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ECONOMIC OUTLOOK

Chamber of Commerce of the United States
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INDUSTRIAL OUTLOOK EXCELLENT, BUT FIRST A WARNING...

by
Richard W. Rahn and Ronald D. Utt

This issue of the our publication is devoted to the Chamber's annual industrial outlook, a comprehensive analysis of the current state of U. S. industry. Focusing on mining, construction and each of the major manufacturing sectors, the Chamber's industrial outlook provides details on how the recovery has improved conditions in each of the key industries, what problems remain and how these sectors are likely to perform over the next several years.

While our prognosis for the future of American industry is excellent, we are again troubled by the recent course of Federal Reserve monetary policy and the implications this could have on our prospects of achieving the high growth path that we believe is within easy reach. Because we view these recent monetary trends with some concern, we would like to devote the remainder of this introductory article to a brief discussion of these trends and how they relate to the high growth scenario.

Our lead article in the last issue of the ECONOMIC OUTLOOK, "Masters of Our Destiny? Why Sustained Rapid Economic Growth is Possible," generated more comment than any other article to appear in this publication. In the few weeks following its release, several major newspapers and magazines, including *Newsweek, The New York Times, Bond Week, The Christian Science Monitor,* and *The New York Post,* published stories based on our growth scenario. With the reelection of President Reagan and the mandate to continue his policies of economic growth and opportunity, this country has moved closer to accepting this agenda as the key objective for the next Administration and Congress.

As we noted in that article, a stable monetary policy conducive to noninflationary economic growth is a key component of a high growth agenda. But as we review the Federal Reserve's action over the past several months, it appears as if we may be in the grips of a major tightening action by the central bank. Indeed, we have to go back to 1981 and 1982 to find instances of comparable restraint. In those years, the Fed's anti-inflationary zeal helped sink the economy into the worst recession of the postwar era. And unless the Fed eases up, and does so quickly, we run the risk of experiencing a similar outcome in the near future.

Just how restrictive this recent policy has been can be readily seen from the trends in the money supply and the monetary base (the raw material from which the money supply evolves and the component that the Fed can directly influence), since early summer. Since June, there has been virtually no growth in the money supply, as measured by M1, or the monetary base. During the first four weeks of October, M1 averaged \$546.4 billion compared to an average of \$546.1 billion during the first four weeks of June. Thus, there has been virtually no growth in the money supply over the past four months, suggesting a degree of restraint that could contribute to economic decline if allowed to continue much longer.

Some might argue that this trend is not indicative of deliberate Fed efforts at restraint because deregulation of deposits has made M1 a less meaningful measure of

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monetary policy and credit conditions. While this might be true under some circumstances, it does not appear to be the case at present because the monetary base, a variable that the Fed can more easily and precisely control, exhibits a similar pattern of slow growth. While it has grown at a somewhat higher rate over the period, its recent growth is still well below trend.

To us, these trends support the concerns we first raised in the March/April 1984 issue of the ECONOMIC OUTLOOK ("Monetary Reform: A Proposal For Bringing the Price and Quantity Rules Together") when we noted that current Fed operating procedures had become highly discretionary and led to erratic swings in monetary growth. Judgment has replaced rules as the Fed attempts to manage the economy on a short run basis in order to achieve economic growth rates consistent with its own notion of what rates were acceptable and what ones were not. As the minutes from the March 1984 Federal Open Market Committee meeting later revealed, the Fed then believed that the economy was growing too fast and that the proper policy objective would be one of restraint. As the trend in the monetary aggregates since early summer now demonstrates, this course is, apparently, the one they pursued.

Although the minutes of the July meeting of the Federal Open Market Committee show less of a concern for too rapid economic growth, it is clear from the summary that such concerns lingered and that the members were wary of deviations on the up side for both economic and monetary growth. In consideration of this possibility, they moved the Federal funds rate range up a notch.

What then seems to have transpired is an illustration of the classic problem associated with undue emphasis on interest rate targets as an operating guide to monetary policy. With the economy slowing at a faster rate than expected and with the Fed prepared to follow higher Fed funds interest rate guidelines, growth in the money supply was restrained beyond that which was anticipated as market interest rates fell below their expected level.

Interest rates, which leveled off on a high plateau over the summer months, have fallen precipitously in September and October. To the casual observer, this has been misinterpreted as a sign of a more accommodative monetary policy. It is not. If anything, the decline in interest rates reflects the financial market's recognition that we are in a period of slow economic growth and reduced credit demands. Related to this is the possibility that the interest rate decline might also reflect renewed confidence in the Fed's steadfast commitment against inflation. If this is the case, then the recent trend in monetary restraint may very well have served to eliminate some or all of the excessive risk premium that has kept interest rates at unusually high levels for the past year. As a consequence, the Fed's recent policy could set the stage for a renewed surge in economic growth in 1985. Such an outcome, however, will require that the Fed ease up within the next month or two.

Although the degree of restraint has been severe, it is not too late to alter the path by allowing the money supply to grow at rates conducive to the rapid, noninflationary economic growth that we have been forecasting for 1985. Inasmuch as Fed policy may now be guided by trends in the real economy, the recent reports indicating some measure of economic deterioration will likely induce the Fed to ease its policy by allowing the money supply to grow at rates within the Fed's target range.

However, we must recognize that the past four months of monetary restraint will likely serve to depress our prospects for economic growth during at least the fourth quarter of 1984 and possibly through the first month or two of 1985. How quickly the economy returns to the 4.5 to 5.5 percent growth path depends upon how quickly the Fed abandons its current policy of restraint. Aside from the temporary but unnecessary hardship that such a policy imposes on certain sectors of our economy, the real danger from this policy comes from the impact the potential stagnation might have upon next year's Congressional deliberations on tax and spending policy. To the extent that growth is unduly depressed, it will be that much more difficult to convince Congress to choose growth over taxes as the only proper policy to reduce the deficit.

In the next several issues of the ECONOMIC OUTLOOK we intend to devote most of our articles to an in-depth discussion of the policies that we believe must be enacted in 1985 to ensure that the high growth objective becomes a reality. These will include detailed articles on tax reform and new tax incentives for growth, our plan for restraining federal spending growth, the need for a stable monetary policy, further deregulation of business and an aggressive program of privatization that would allow the private sector to assume responsibilities now fulfilled, expensively and inefficiently, by government. For now, we turn your attention to the industrial outlook by Rajni Bonnie Ohri and Graciela Testa-Ortiz.

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TABLE 1

UNITED STATES ECONOMIC OUTLOOK 1983-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS									YEARS			
	Actual		Forecast							Actual	Forecast		
	84:2	84:3	84:4	85:1	85:2	85:3	85:4	86:1	86:2	1983	1984	1985	1986
GROSS NATIONAL PRODUCT													
Real GNP	7.1	2.7	3.6	4.1	5.0	5.2	5.3	5.1	5.1	3.7	6.9	4.4	5.0
Consumption	7.9	0.2	4.4	3.5	5.1	4.0	4.2	3.7	3.6	4.8	5.3	3.9	3.8
Residential Investment	1.3	2.7	0.9	16.1	6.4	10.3	8.8	7.2	2.6	41.7	13.5	7.2	5.3
Business Fixed Investment	21.4	7.9	11.0	9.8	14.2	10.7	9.9	10.4	10.8	2.5	19.2	11.4	10.8
Equipment	21.2	10.5	12.4	10.5	14.8	11.1	9.9	10.2	10.6	7.3	20.9	12.3	10.7
Structures	21.3	1.8	7.4	8.1	12.7	9.6	9.9	10.9	11.3	-7.8	14.9	9.1	10.8
Exports	-0.6	16.1	11.7	8.1	9.1	10.4	11.2	11.5	13.1	-5.6	6.5	9.8	11.6
Imports	8.1	49.8	11.0	7.2	7.8	6.6	4.1	3.1	2.5	7.6	30.0	12.2	3.8
Government Purchases	18.6	8.6	5.6	2.8	3.0	2.8	1.3	1.0	1.2	-0.3	3.9	4.9	1.4
Inventory Change ($ B)	50.6	72.4	60.1	56.4	48.4	50.0	51.7	53.9	55.0	-13.5	64.2	51.6	54.7
New Car Sales (mil. units)	10.7	10.3	11.0	11.0	11.0	11.1	11.3	11.5	11.6	9.2	10.6	11.1	11.6
Housing Starts (mil. units)	1.9	1.7	1.7	1.8	1.8	1.9	1.9	2.0	1.9	1.7	1.8	1.8	1.9
EMPLOYMENT, WAGES AND PRICES													
Unemployment Rate (%)	7.5	7.5	7.3	7.2	7.0	6.8	6.6	6.4	6.2	9.6	7.5	6.9	6.2
Compensation	3.7	3.4	4.6	6.2	5.5	5.8	6.6	7.5	7.0	4.8	4.2	5.2	6.8
Productivity	4.6	2.3	4.5	3.5	2.1	2.9	3.4	4.0	3.1	3.4	3.2	3.2	3.2
Unit Labor Costs	-0.8	0.8	0.1	2.6	3.3	2.9	3.1	3.3	3.8	1.3	1.0	1.9	3.6
Consumer Prices	3.7	3.6	3.7	3.3	3.6	3.8	3.4	4.1	4.4	3.2	4.2	3.6	4.0
GNP Deflator	3.3	3.6	3.7	3.7	2.8	2.8	3.9	4.0	4.6	3.8	3.8	3.4	4.1
Prime Interest Rate (%)	12.3	13.0	11.5	10.8	10.2	10.0	9.5	9.3	9.0	10.8	12.0	10.1	9.1
Profits from Current Production ($72B)*	195.2	203.4	207.4	209.3	214.5	222.2	232.5	230.6	233.9	149.4	197.7	219.6	235.1
GOVERNMENT FISCAL POLICY ($BILLION)**													
Unified Budget—Receipts										601	666	759	842
Unified Budget—Outlays										796	842	920	975
Unified Budget—Federal Surplus or Deficit										-195	-175	-161	-133

* Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast adopts all the provisions of previously enacted legislation, including indexation of personal income tax rates and the recently passed Deficit Reduction Act of 1984. No additional fiscal policy changes are assumed.

THE U.S. INDUSTRIAL OUTLOOK

by

Rajni Bonnie Ohri and Graciela Testa-Ortiz

Although the data clearly show that the 1981 changes in the tax law played a major role in laying the groundwork for a return to a period of long-term economic prosperity, much continues to be said about the unevenness of the recovery across industries. This perception persists in spite of the unprecedented surge in business investment and job creation, which have been amply documented during the past few months. This paper studies several issues relating to industrial performance. First, we look at the long term decline of the manufacturing sector as a source of employment, and the implications of that decline for the future of our economy. Second, we examine the pattern of cyclical recovery in the major indicators of industrial activity. Third, we focus on two major factor affecting the nation's industries—the explosion in new technology and import competition. Finally, the fourth section provides a detailed analysis of industrial conditions and prospects.

THE SHIFT AWAY FROM MANUFACTURING

In spite of the success of this expansion in creating new jobs, an analysis of industrial employment data points to a definite slide in manufacturing employment which has caused concern in public policy circles. Total nonfarm employment rose at an average annual rate of 1.9 percent between 1976 and 1983, but manufacturing employment fell by 0.4 percent each year. At the same time, employment in the services industries rose an impressive five percent per annum. The decline in the rate of growth in manufacturing employment has been pervasive, including virtually every manufacturing industry, with the notable exception of electrical machinery and instruments (see Table 1).

However, this trend is not a recent phenomenon. The percentage of total employment created in the manufacturing sector has been falling steadily since the 1950s (see Chart 1). While manufacturing employment accounted for 32 percent of total employment in 1950, the ratio has fallen to 21 percent today. Nor is it unique to the United States. Several of the major industrialized nations have experienced a phenomenon similar to ours. Taking the seven largest OECD nations together (the U.S., Japan, West Germany, France, the United Kingdom, Italy, and Canada) we note that the percentage of civilian employment in the manufacturing sector fell from 27 percent in 1960 to 24.6 percent in 1981. The decline in Canada was similar to that in the United States, dropping from 24.6 percent in 1960 to 21 percent in 1981; while it was even more pronounced in the United Kingdom, falling from 38 percent in 1960 to 28 percent in 1981.

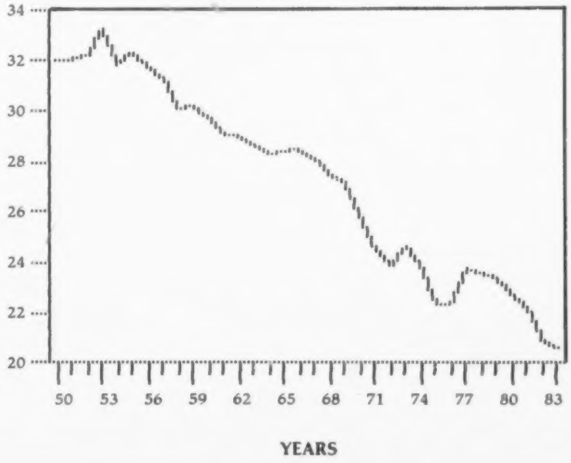
TABLE 1
INDICATORS OF INDUSTRIAL ACTIVITY
(annual average percent change, 1976 to 1983)

	Employment	Output[1]	Productivity[2]
Nonfarm, total	1.9	2.6	0.8
Manufacturing	-0.4	1.7	2.1
Nondurables	-0.4	1.7	2.1
Food and Kindred Products	-0.6	1.2	1.4
Tobacco	-1.3	-3.5	-0.2
Textiles	-2.7	2.3	2.6
Apparel	-1.7	1.5	0.9
Paper & Products	-0.3	2.4	0.8
Printing & Publishing	2.6	3.2	-0.1
Chemicals	0.1	2.1	1.0
Petroleum	-0.3	-0.5	-1.2
Rubber & Plastics	1.7	4.3	0.4
Leather & Products	-3.0	-2.6	0.2
Durables	-0.4	1.6	2.1
Lumber & Wood Products	-0.5	-0.1	0.3
Furniture & Fixtures	0.1	2.4	0.2
Stone, Clay & Glass	-1.6	-0.7	-0.4
Primary Metals	-3.9	-3.2	0.5
Fabricated Metals	-1.3	1.2	-0.5
Nonelectrical Machinery	-0.2	2.5	2.9
Electrical Machinery	2.0	8.3	4.3
Transportation Equipment	-0.3	-0.7	-2.9
Instruments	3.0	5.5	3.2
Miscellaneous	-1.9	0.3	0.6
Mining	3.2	10.1	NA
Construction	1.4	-4.9	NA

[1] Output represents constant dollar gross domestic product in each industry.

[2] Output per employee hour. Data for individual industries available through 1981 only.

CHART 1
MANUFACTURING EMPLOYMENT
AS % OF TOTAL



This outcome, however, should not come as a surprise, nor as a cause for concern. The British economist, Colin Clark, noted 30 years ago that market economies tend to pass through three, readily identifiable stages of economic development. Underdeveloped economies, what he called primary economies, are characterized by their dependence on agriculture and raw materials as a major source of employment. The second stage of development, he noted, was a stronger dependence on the manufacturing sector. While in a developed, or tertiary, economy the service sector is the major source of jobs. This industrial shift is a logical consequence of economic progress, reflecting improvements in productivity and national income.

As incomes rise the pattern of consumer behavior shifts from an emphasis on purchases of consumer durables to a rising use of services, including cultural, educational and household services which raise the quality of life and make it possible for people to enjoy a greater amount of leisure. While these shifts in consumption patterns follow increases in income, they are also made possible as a result of innovations which increase efficiency and productivity in each sector. For instance, with the advent of farm machinery, agricultural productivity rose sharply and it became possible to produce significantly larger farm yields with a reduced number of farm workers. Similarly, technological innovation in the field of computers, telecommunications, and robotics has made it possible to increase manufacturing production and distribution, and to reduce the number of workers needed in the assembly line. Another factor which intensifies this effect is the rising age of the American population which increases the demand for services such as medical care.

Given these considerations, the decline in the importance of the manufacturing sector should not be seen as a negative development. It is, rather, a reflection of economic progress. If we were to note that not only employment, but also output and productivity were suffering such a long term decline, then we would certainly have cause for concern. However, as Table 1 also shows, both output and productivity have continued to rise strongly.

This underlying trend in manufacturing employment, however, has not prevented the nation's industries from participating in the 1983 recovery and the current economic expansion. In fact, the data for the first six quarters of this upturn show that, far from stagnating, the manufacturing sector is growing apace with, and in some cases faster than, the overall economy. Manufacturing continues to be a vibrant sector of the American economy, whose prospects have been enhanced, as we shall see, by the surge in new technology of the past few years.

THE 1983 RECOVERY: INDUSTRY EXPERIENCE

Gilt-edged is one way to describe the comeback of many major industries. Output, industrial production, plant and equipment expenditures, employment, profits, and productivity have all increased significantly since the end of the recession.

This solid upswing in industrial performance, particularly manufacturing, reflects the fundamental changes occurring in the U.S. economy as a result of the 1981 tax legislation. In spite of the massive tax increase enacted in 1982, the Accelerated Capital Recovery System (ACRS), which was an integral part of the 1981 tax legislation, went a long way towards reducing the cost of capital and spurring business investment and productivity, yielding the strongest investment recovery on record. Obviously, had the Tax Equity and Fiscal Responsibility Act (TEFRA), which rescinded a large portion of the 1981 tax relief, not been enacted in 1982, the recovery would have been all that much stronger.

Plant modernization and new product development programs have been a logical focus of the rise in plant and equipment expenditures, placing American industries on a stronger competitive footing. Intense foreign competition has spurred U.S. industries to down-size and otherwise improve its product lines through record high levels of capital spending.

Output and Industrial Production

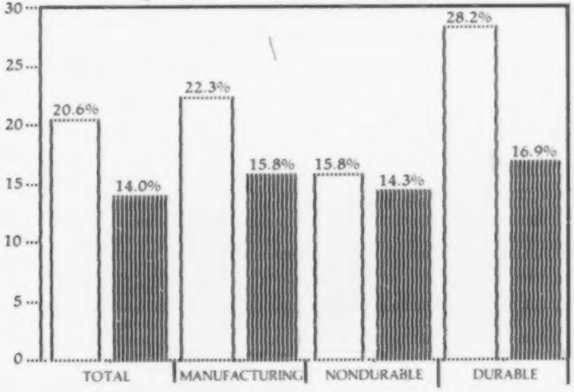
Manufacturing sector output (gross domestic product), which rose at an average annual rate of 1.7 percent between 1976 and 1983, fell by 6.4 percent in 1982 as a result of the recession-induced falloff in demand, but rebounded by 5.2 percent during 1983 as the recovery gathered strength. Within the manufacturing sector, several industries, in particular those related to the housing and automobile sectors, posted significantly higher increases in output. Output in the lumber, furniture, and stone, clay and glass industries rose by almost twelve percent in 1983, after suffering significantly larger than average declines in 1982. The rubber and plastics, electrical machinery, chemicals, paper, textiles and fabricated metals industries also enjoyed substantial improvements. Nor was this improvement limited to the manufacturing sector. With the exception of mining, the nonmanufacturing sectors also enjoyed cyclical recoveries in line with the experience of the 1976-1983 period (see Table 2).

Similarly, total industrial production rose by 20.6 percent since the end of the recession, compared to an average rate of growth of only 14 percent during

TABLE 2
REAL GROSS DOMESTIC PRODUCT
(year-over-year percent change)

	1982	1983
Nonfarm, total	-2.0	3.8
Manufacturing	-6.4	5.2
Nondurables	-2.6	4.5
Food and Kindred Products	2.0	-1.6
Tobacco	-0.4	-10.1
Textiles	-4.6	9.8
Apparel	-7.3	7.3
Paper & Products	-2.0	13.1
Printing & Publishing	0.2	4.7
Chemicals	-5.7	6.6
Petroleum	-4.4	-1.5
Rubber & Plastics	-5.0	9.6
Leather & Products	-3.7	-1.7
Durables	-9.0	5.7
Lumber & Wood Products	-6.9	11.9
Furniture & Fixtures	-10.3	11.6
Stone, Clay & Glass	-11.3	11.5
Primary Metals	-28.2	4.6
Fabricated Metals	-9.7	6.5
Nonelectrical Machinery	-9.2	-4.1
Electrical Machinery	-2.0	5.5
Transportation Equipment	-8.8	17.1
Instruments	3.5	0.6
Miscellaneous	-10.8	-0.2
Mining	-4.0	-2.7
Construction	-2.4	2.7

CHART 2
COMPARISON OF THE GROWTH OF INDUSTRIAL PRODUCTION IN THE FIRST SIX QUARTERS OF ECONOMIC EXPANSION



OUTLINE = CURRENT RECOVERY
SOLID = AVERAGE PAST 3 RECOVERIES

similar periods of the past three recoveries (excluding the 1981 recovery which did not last this long). The durable goods sector has been particularly strong, posting a 28.2 percent increase in industrial production, compared to an average recovery rise of only 17 percent during previous episodes. The fuel for this surge in industrial production in durable manufacturing came from the stone, clay and glass, primary and fabricated metals, and electrical and nonelectrical machinery industries, which posted dramatic increases in production. Production in the nondurable goods sector, however, was only slightly above the typical recovery experience (see Chart 2).

Nevertheless, some industries, particularly nondurables, remain weak. The industrial production recovery in the food and kindred products, tobacco, petroleum, and leather products industries has, so far, been below the average for past recoveries. Real gross domestic product (output in 1972 dollars) continued to decline in these industries during 1983. The same is true of machine tool producers, which fall under the nonelectrical machinery category. Although industrial production in this industry enjoyed a respectable increase during the past year and a half, real GDP continued to fall during 1983, albeit at a significantly slower rate than in 1982. All of these industries, however, are the victims of special circumstances, such as shifts in patterns of demand (e.g. tobacco), competition from imports (e.g. leather and machine tools), and oversupply (e.g. petroleum). In the case of tobacco and petroleum products, there is very little that these industries can do to reverse the situation in the short run. But, both the leather and nonelectrical machinery sectors have engaged in significant increases in plant and equipment expenditures geared towards improving efficiency of production and international competitiveness.

Plant and Equipment Spending and Employment

The data on plant and equipment expenditures, and employment closely parallel the increases in gross domestic product and industrial production. These indicators show that the recovery has been quite widespread. The data do, in fact, show that some industries have enjoyed faster increases than others during the current economic expansion. However, it also shows the strongest rates of improvement for those industries that have been portrayed as declining. For instance, while total, inflation-adjusted expenditures on plant and equipment in the nation's nonfarm industries rose by ten percent since the beginning of the recovery, the bulk of the increase was in the manufacturing sector, which enjoyed an almost 17 percent rate of growth compared to only 6.3 percent for the nonmanufacturing sector. In the durable manufacturing sector all the industries, with the exception of stone, clay and glass, and fabricated metals, showed improvements significantly above the average for all nonfarm industries. While in the nondurables category, all industries, with the exception of food and beverages, enjoyed increases in plant and equipment spending that were double the average for all industries (see Table 3).

TABLE 3
REAL PLANT & EQUIPMENT EXPENDITURES RECOVERY EXPERIENCE
(% change)

	82:4 to 84:2	75:1 to 76:3	70:4 to 72:3	61:1 to 62:3
Nonfarm, total	10.0	-1.3	3.4	8.9
Manufacturing	16.8	-1.4	-8.0	3.5
Nondurables	15.9	1.2	-5.0	2.1
Food and Kindred Products	-9.4	11.1	-6.8	-5.2
Textiles	21.5	13.9	32.1	5.6
Paper & Products	21.5	-4.5	-16.5	-11.6
Printing & Publishing	19.9	-1.8	-4.3	2.9
Petroleum	19.4	5.9	-13.1	8.4
Rubber & Plastics	24.1	-8.9	14.3	8.7
Durables	17.7	-4.0	-10.8	4.9
Stone, Clay & Glass	3.6	0.0	17.4	16.5
Primary Metals	15.7	-4.1	-33.2	-15.3
Fabricated Metals	9.7	0.6	8.0	14.1
Nonelectrical Machinery	16.1	-6.3	-16.9	11.1
Electrical Machinery	28.7	6.7	-18.6	-10.1
Transportation Equipment	17.8	-9.9	-2.3	16.5
Motor Vehicles	33.9	-12.3	6.4	7.5
Instruments				
Miscellaneous				

This surge in investment was reflected in healthy increases in industrial employment. Total nonfarm employment has risen by 5.1 million jobs since the end of the recession, a 5.7 percent increase. Manufacturing employment rose by 8.1 percent, mainly on the strength of a 10.7 percent increase in durable manufacturing employment.

While these results are very encouraging and certainly should dispel the notion that the recovery has left major industrial sectors behind, it is a fact of economic life that the manufacturing sector, and durable manufacturing in particular, is extremely sensitive to business cycles. As a result, their stronger than average recovery should come as no surprise since these industries also suffered higher than average employment losses during the recession. What does make this recovery remarkable, however, is its strength relative to previous recovery experience.

The recent ten percent increase in total plant and equipment spending was preceded by a a 0.5 percent *decline* during the 1975-1976 recovery and a 3.9 percent increase in 1970-1972. This higher than average performance is also evident when the data is disaggregated by industry. Expenditures for manufacturing plant and equipment rose by almost 17 percent during the past year and a half, compared to an average *decline* of two percent during the past three recoveries. Investment in manufacturing durables rose by 17.7 percent compared to an average *decline* of 3.3 percent, the increase in investment was particularly strong in the electrical machinery and motor vehicles sectors (see Table 3).

As can be expected, the rate of job creation has also been significantly stronger than the average for the typical recovery. The 5.7 percent increase in total nonfarm employment compares favorably to an average recovery increase of only 3.5 percent. Durable manufacturing employment rose by almost eleven percent since the end of 1982, compared to 2.3 percent in 1975-1976, and 3.4 percent in 1971-1972. The strongest employment increases were in the lumber, furniture, electrical machinery, and transportation equipment industries. In the nondurables sector, only rubber and plastics parallelled the strength evident in durables (see Table 4).

TABLE 4
INDUSTRIAL EMPLOYMENT IN THE FIRST SIX QUARTERS OF ECONOMIC EXPANSION
(% change)

	82:4 to 84:2	75:1 to 76:3	70:4 to 72:3	61:1 to 62:3
Nonfarm, total	5.7	3.7	4.1	4.3
Manufacturing	8.1	3.3	2.3	4.9
Nondurables	4.6	4.7	0.8	2.6
Food and Kindred Products	1.1	3.1	-0.8	-0.6
Tobacco	-1.5	4.9	-6.1	1.1
Textiles	4.8	10.5	2.9	2.0
Apparel	7.1	8.9	2.6	5.6
Paper & Products	4.3	4.4	-0.6	3.4
Printing & Publishing	6.6	1.0	0.0	1.6
Chemicals	0.4	2.2	-2.3	3.5
Petroleum	-5.5	4.2	2.8	-5.4
Rubber & Plastics	17.0	2.1	10.0	14.7
Leather & Products	-1.6	8.6	-3.2	0.4
Durables	10.7	2.3	3.4	6.9
Lumber & Wood Products	19.5	15.4	12.0	3.1
Furniture & Fixtures	13.7	8.1	10.9	7.9
Stone, Clay & Glass	8.4	1.3	6.1	4.1
Primary Metals	7.2	-1.6	-3.8	3.8
Fabricated Metals	8.9	2.8	3.6	7.7
Nonelectrical Machinery	7.5	-2.5	-0.4	6.8
Electrical Machinery	14.1	2.4	1.5	8.8
Transportation Equipment	14.8	3.8	9.4	9.9
Instruments	3.3	2.8	1.1	4.8
Miscellaneous	5.0	6.3	3.7	4.8
Mining	-3.5	5.5	0.4	-4.7
Construction	12.1	-2.3	8.3	5.6

Productivity

The data on productivity reflect the sharp increases in output and investment. Between 1976 and 1983, total manufacturing productivity, as well as productivity in the durables and nondurables sectors, rose at an average annual rate of 2.1 percent. Data for 1982, 1983 and the first half of 1984 show that while productivity growth slowed during the recession, the turnaround during the past six quarters far outstripped the 1976-1983 average, and that improvement was particularly strong in the durable manufacturing sector. While total productivity in the nonfarm business sector rose by almost six percent since the recovery began, manufacturing productivity rose by 6.9 percent, largely on the strength of an almost nine percent rise in the durable goods sector. The strong increase in output during 1983, which was the result of sharp improvements in plant and equipment spending, was, in turn, largely responsible for rising productivity.

Profits

After suffering through a recession, which in some cases, as in the construction industry, began as far back as 1978, most industries saw profits rebound dramatically as the recovery gathered strength. The rise in corporate profits during the second quarter reflected the big gains in consumer and business spending. Impressive gains in labor productivity held down the rise in unit labor costs, further aiding profits. Two industries, automobiles and steel, which were hard hit by the recession and by competition from foreign imports, reported their best quarterly earnings since 1981. In the quarter just ended, the auto industry turned in a stellar performance. Automakers will be hard pressed for an encore to top their recent achievements: record after-tax profits of $5.7 billion last year, followed by profits of $3.1 billion for the first quarter of this year. Profits at the Big Three auto makers soared 75 percent from a year earlier. Other industries which enjoyed substantial increases in profits include cement, farm equipment, nonferrous metals, and machine tools. Huge gains in net income were reported by such groups as airlines, building supplies, forest products, specialty electrical equipment, railway gear, and rubber.

A NEW WAVE OF INNOVATION IS STRENGTHENING AMERICAN INDUSTRY

A new era of manufacturing is emerging which is enabling firms to turn out a greater diversity of product models through the use of computer technology. Nowhere is this fundamental change more evident than in the automobile industry. Pinned against the wall by import competition, it was the first U.S. basic industry to make an industry-wide commitment to high technology. The auto industry has spent vast amounts of funds building new factories and modernizing old ones. That trend is now spilling over to suppliers of auto firms.

In the footsteps of the auto industry, other major industries to seriously pursue high technology have been heavy equipment manufacturers and machine tool builders. Throughout the heavy equipment industry—at Caterpillar Tractor, International Harvester, Ingersoll-Rand and others—advanced technology is coming on apace. But the shining example is Deere & Co. Its sprawling Tractor Works in Waterloo, Iowa is considered by many to be the nation's ultimate state-of-the-art manufacturing facility. Machine tool builders stepped up their interest in innovation after watching their traditional dominance of the world market slide into a net trade deficit. Their newly aroused concern has coincided with the availability of low cost electronics, which made it possible to design sharply improved capability into their products.

In the textile industry, which has suffered extensive damage through competition from imports, new generation machines clean cotton and other fibers ten times faster than was possible a decade ago. Looms produce a hundred yards of cloth an hour—twice as fast as ten years ago.

THE COMPETITION FROM IMPORTS

A rising tide of imports of both consumer and capital goods has been a major characteristic of this recovery. Real imports rose by 25 percent in 1983 buoyed by a strong dollar which makes foreign products comparatively less expensive in U.S. markets. In contrast to previous import invasions, the fastest growing category of imports this time around is capital goods. In the first half of 1984, capital goods imports were fifty percent higher than a year earlier, and were coming in at an annual rate of $58 billion. Since 1979 capital goods imports have more than doubled.

Stiff competition from foreign producers in U.S. and foreign markets has been blamed for the decline in manufacturing. Paradoxically, some of the industries which have been hurt by import competition are themselves heavy importers. For instance, in their drive to modernize, textile producers have equipped their factories with state-of-the-art German looms. Machine tool manufacturers, another victim of rising imports, are, in many cases, themselves importing various machinery. Almost 33 percent of U.S. machine tool sales in 1983 were imports. Even in the high technology industries, imports are rapidly making inroads. In the manufacturing industries, the import penetration ratio (the ratio of imports to new supply) rose from 7.7 percent in 1974 to 9.1 percent in 1981. In the tobacco, apparel, leather, and miscellaneous manufactures industries the ratio almost doubled during the 1974-1981 period.

The dollar's strength, however, has only exacerbated the erosion of the competitive position of U.S. manufactures. A well known fact of foreign trade is that American industry has, until recently, not recognized the full potential of foreign markets and has not embarked in vigorous export programs. Because of the large size of our domestic market, many companies, in the past, felt less urgency about opportunities abroad, and failed to make the sustained investments needed to develop overseas markets. Another reason why U.S. manufacturing has lost its competitive edge is the extremely high cost of factors of production—both labor and capital—which has placed the U.S. at a competitive disadvantage with respect to developing nations such as Brazil and Korea which enjoy lower labor costs, and Japan where the cost of capital is significantly lower.

The cost of capital issue is one that we touched upon more than a year ago (see "Corporate Health: How Sick is the Patient?" in the May 1983 issue of ECONOMIC OUTLOOK), and has been amply documented. Manufacturing industries are limited in their use of debt in large part as a result of their cyclicality. Heavy use of debt financing would result in heavy losses and even bankruptcy for those firms where demand for their products drops off sharply during economic downturns. This will always happen as a result of the very nature of these products. Whereas purchases of nondurables, such as food, cannot be significantly reduced when incomes decline, purchases of consumer durables are easily postponed in periods of economic hardship. With regard to equity financing, U.S. manufacturing firms are severely hindered by tax laws, such as a double taxation of dividend income, which increase the cost of capital. High labor costs in the United States have also been amply documented. Comparisons across countries show that we have one of the highest labor costs in the world.

INDUSTRY DETAIL

While the basic factors underlying the problems of U.S. manufacturing have been touched upon, additional insights are gained by examining individual industries. Clearly, specific events and decisions have served an important role in determining each industry's performance. Also, competitive positions differ substantially among industries.

Construction

After two years of recovery, the dynamics of the building cycle are shifting from residential to nonresidential building. Total new construction increased sharply in 1983 after four years of decline, largely because of the dramatic rise in private residential construction. The turnaround was a result of the decline in interest rates that occurred in the second half of 1982 and in the beginning of 1983. In contrast, private nonresidential construction declined, largely because industrial construction was depressed by recession in the manufacturing industries and because the office building boom began to subside. In general, the heavy construction industry was held back last year by excess capacity, a general weakness in capital spending and a steep decline in energy exploration.

While the mid-summer rise in mortgage interest rates did result in a lower level of starts in the third quarter, housing recovered in September as interest rates fell in August and September. As interest rates continue to ease, the housing sector is likely to get a second wind. The ability of the economy to sustain the new housing construction recovery that started in 1983 will be important for both producers of materials used in new homes and for additional construction activity. New housing has increased the needs for various types of commercial and institutional buildings, and has influenced construction requirements for additional schools, roads, and other public infrastructure.

The nonresidential building cycle, in typical fashion, lags a year behind the housing market, leaving much of its potential still to be realized. The retail building market (stores and warehouses) is on its way to two years (1984 and 1985) of high volume building as it responds to needs created by the recent surge of residential building. The extraordinary office building boom of the past five years, which produced as much new office space as was built in the previous ten years, began with the firm support of strong demographics. During the remainder of this year and into 1985, nonresidential building will be increasingly dominant as the housing boom slows down.

Lumber and Wood Products

Last year was regarded as "choppy" for the forest products industry. The year began with a strong surge in the demand for building products as the housing market recovered. Forest products companies, currently enjoying a burst in demand for paper products, see 1985 as a year of solid sales and profit gains. This upbeat outlook may seem surprising for an industry that just a year ago was rife with unemployment. But 1983 and 1984 provided a healthy rebound for the lumber side of the industry. The demand for lumber depends to a great extent on the level of residential construction, which is forecast to improve substantially during the next five years. Lumber prices initially picked up in 1983, reactivating all of the industry's capacity, and resulting in an oversupply situation which caused a subsequent sharp drop in prices. Despite continuing weakness in the lumber and plywood markets, earnings rose sharply and should stay strong throughout this year and next.

In recent years, forest products companies have invested heavily in labor-saving techniques and have kept a tight lid on capital spending. The U.S. is usually a net exporter of wood products but in the first half of 1983, imports exceeded exports. Canada supplied nearly all (97 percent) of U.S. lumber imports in 1983. Since lumber is priced in the world markets, the high value of the U.S. dollar is reflected in the relatively low domestic prices. The U.S. share in world markets is believed to be diminishing as countries such as Canada, compete more effectively and dominate a larger share of the market.

Stone, Clay and Glass

The stone, clay and glass industry remains sensitive to shifts in interest rates and particularly, to the general performance of the construction industry. Thus, the industry benefited from dramatic increases in residential and nonresidential construction in 1983. If the expansion continues at a healthy pace through 1985, as we believe it will, strong rates of production growth can be expected to continue in this industry as well. The surge in the housing market and the serious efforts in some parts of the country to repair crumbling infrastructure resulted in record demand for products such as cement. After restructuring its facilities, the industry began to open new, more efficient plants to meet the growing demand. As a result, profit levels spurted by 155 percent. Although employment growth has been slow, productivity shows an above average trend.

The import penetration ratio rose sharply from the mid-1960s to 1980 and the U.S. share in world export markets declined. As a result, the industry trade deficit expanded and reached $0.5 billion in 1982. Canada is by far the largest construction material supplier to the U.S. and also the major customer for U.S. exports. Some U.S. producers have sizeable markets in Central and South America and in the Middle East.

Nonferrous Metals

The nation's nonferrous metals industry should show a marked improvement in 1985. Even though the industry finished 1983 in the red, it was a time of recovery for most nonferrous metals producers. By the middle of this year, some producers were operating at near capacity, compared with about 75 percent at the beginning of 1983. Major nonferrous metals producers are enjoying an upward momentum that should enable them to achieve a significant improvement next year. Producers' inventories are declining, consumption is picking up, and prices are stabilizing. Aluminum, for one, is already in a recovery.

The industry, which includes producers of molybdenum, nickel, lead, zinc, copper and aluminum, is still beset with problems that made the recent recession the worst period in its history. The main problems were overcapacity and tough foreign competition. Some metals have special problems of their own which are independent of general business conditions. A case in point is lead. Lead producers are going to have to find new markets to make up for its being phased out of the paint and gasoline business. Similarly, copper is facing market losses due to substitutes such as fiber optics in the telecommunications industry, and plastic pipes in plumbing.

The demand for aluminum has been revived by the surge in autos, housing and consumer durables. Although the largest U.S. producers—Aluminum Co. of America and Reynolds Metals Co.—have chalked up improved sales and earnings this year, the domestic industry has had to shutter 8.5 percent of its primary aluminum production in an effort to bolster prices. Martin Marietta's withdrawal from aluminum is the latest development in a dramatic restructuring of the world industry—a shakeup in which high-cost primary aluminum production is shifting from the U.S. to Canada, Brazil and Australia, where the cost of energy is much lower. Also contributing to the industry's upheaval is the strong U.S. dollar, which in recent years has attracted record-level imports of low-priced, foreign aluminum into the U.S.

The outlook for other nonferrous metals also hinges on the continuing strong recovery in autos and housing. Zinc consumption has increased this year and should continue to rise in 1985. For practically all nonferrous producers the reduced level of inventories will be an upbeat factor for 1985. For the past two years, persistently high supplies severely depressed most nonferrous metal prices, forcing a succession of mine closings. Now, because molybdenum producers have slashed their mine output by 65 percent last year alone, stockpiles have shrunk. The situation in copper, however, is more troubling. U.S. producers are hampered by oversupply and plagued by low-cost foreign copper that continues to flood into the country. As copper prices have dropped, mines in Third World countries have increased their output to make up for lost revenues. U.S. copper producers are asking the Administration to penalize countries, such as Chile and Zambia, that are the most deeply indebted to U.S. banks and depend heavily on copper revenues to service their debt. This has created a supply-demand imbalance, pushing the price of copper below seventy cents a pound. Because of the huge inventory overhangs, copper prices are expected to average only 63 cents a pound next year.

Despite the sharp decline in employment, wages in the industry have risen very sharply to a level nearly fifty percent above the economy's average. This industry suffered the largest decline in output, productivity and employment among all the manufacturing industries during the 1974-82 period. Recently, investment in this capital-intensive industry has been falling. Further, an increasing share of the investment is now devoted to some of the newer fields into which companies have diversified rather than to modernization of the existing industry. The import penetration ratio has been rising rapidly, and in 1982 approached twenty percent. The industry's trade deficit was a very large $11.3 billion in 1983.

Steel

In 1983, the steel industry hesitantly emerged from the disastrous 1982 experience of low output, high unemployment, and large financial losses. In addition, the import share of steel shipments has increased from six percent in 1965 to near 25 percent this year. During the past year, production has also dropped by forty percent. Although, production and shipments have gradually improved this year, some markets, particularly for flat-rolled products are doing better than others due to the increased automotive and appliance demands. Firms specializing in these products showed larger gains in earnings than companies devoted to plate, large structural, rail and pipe products.

The Administration has approved a program of voluntary import quotas as its version of a plan to save the steel industry. Although the plan has no built-in enforcement mechanism, the Administration expects that it will bring steel imports down to 18.5 percent of the American market from the current 25 percent. Still, hope springs eternal and the industry is encouraged by the modest $124 million profit earned during the beginning of this year. With industries such as autos and appliances booming, shipments are mounting; they should rise 15 percent by year-end and eight percent in 1985.

The energy crisis of the 1970s is one reason for lower steel consumption (the average American-made car now contains some 600 fewer pounds of steel than it did in 1976). Another reason for the decline in steel demand is the steady shift away from goods produced by heavy industry toward electronics, services, and information processing (there is no steel in a microchip). Steel producers are confronting their shrinking market by eliminating inefficient capacity; the industry is operating at only 57 percent of capacity. Even with rising consumption and a large swing in customers' net inventory positions last year, shipments remained below seventy million tons for the second straight year. Big steel producers will continue to face intense competition from both imported steel and the rise of domestic mini-mills. These mini-mills have already grabbed over 15 percent of the U.S. market and are expanding rapidly into new products.

A major drag on the industry has been import competition. Major U.S. producers cannot compete effectively in such lines as bars, rods and wires. Their most recent strategy has been to abandon noncompetitive products and plants and to carve out niches in product lines where they can be competitive, namely, sheet products, plate, and structural steel. But that will require massive investment in new facilities and new technology. It appears that steel's road to recovery will be slow and difficult for the next few years.

Nonelectrical Machinery

There has not been much good news in the machine tool industry since 1979. Only a slow pick-up is anticipated and many companies do not expect to return to profitability until late 1985. Severe overcapacity and weak pricing forced all the major companies to restructure operations. The industry is also plagued by tough foreign competition as imports dominate about 42 percent of the U.S. market this year, as compared to 32.5 percent in 1983. And in two key products—numerically controlled lathes and machining centers—imports account for over two-thirds of all U.S. sales. As Third World markets struggle for a share of the machine tools industry, the strength of the U.S. dollar, high interest rates, and lagging foreign markets will hold U.S. exports to marginal gains. Some firms slashed employment as much as fifty percent between 1981 and 1984, and many old-line plants were closed. But, at the same time, plants which were competitive were expanded and companies opened new, more highly automated facilities.

Robot producers expect substantial growth and machine-tool builders say their customers are demanding more computer-controlled equipment to increase production efficiency. It appears that companies will have to put more effort into engineering and spend more time on the computerization of their business. Technology will remain a key factor as the industry continues to search for even more efficient applications of the computer to machines and industrial processes.

If there ever was a time for an entire industry to change, it was the early 1980s for the industrial equipment makers. Demand in all product lines—

industrial, construction and agriculture—hit previously unseen lows. The industry has closed down facilities and cut deeply into employment in a struggle to reduce break-even points. Last year the tough times brought widespread price-cutting in an effort to reduce unwanted inventories. But persistently high interest rates still dampened sales. Next year does not promise much improvement in sales unless there is a total restructuring of the industry. Exports are expected to grow 11 percent in 1984, and will continue to account for over thirty percent of total shipments of industrial machinery. Imports should also rise by over ten percent.

The government's agricultural Payment-in-Kind (PIK) program, which took over eighty million acres of land out of production, has also hurt the demand for agricultural equipment. Drastic cost-cutting and gains in other businesses helped some tractor and combine makers to regain profitability and others to narrow losses. Agricultural equipment producers are estimating that retail sales should rise about ten percent this year and next, but that will hardly be sufficient to pull the industry out of the red. In an industry that has been needing to consolidate for years, the bleak forecast for 1985 intensifies the likelihood that some manufacturers will bail out by next year. The question troubling farm suppliers is whether the recovery in agriculture will be sustained into 1985 and beyond. Farm equipment makers also see a threat from Japanese companies who are looking to expand into the larger equipment lines.

Computers

In 1984, the demand for computers—for both personal and business use—has been called insatiable. Revenues for the computer industry will grow at a rate of twenty percent a year through 1984 and well into 1985. Even during 1983, when demand recovered from a soft spell induced by lower capital spending, a highly competitive atmosphere put pressure on the margins of even the giant companies. A shift in consumer preferences toward leasing rather than purchasing data-processing equipment, placed unusual demands on the corporate cash flow of some vendors. It is expected that the dollar value of shipments of personal computers will increase by 38 percent between now and 1987.

Higher capital spending this year should mean faster growth for the information processing industry which generally lags behind other businesses in a recovery. IBM, the giant of the industry, expects revenues to increase by twenty percent this year and next. Many minicomputer makers will profit only modestly as inexpensive microcomputers are capturing the market. New software companies will provide programs for the flood of personal computers in automated offices and expect sales to increase by fifty percent next year.

The healthy U.S. trade surplus in computer equipment is shrinking—$6.2 billion in 1983 from $8 billion in 1982. This, in part, is due to the growing ability of foreign suppliers, particularly those in the Far East, to provide low-cost products. Overseas business should pick up as the recovery strengthens in Europe, but those sales will come mainly from offshore plants.

Electrical Machinery

The electronic and electric equipment industry had the highest rate of output growth and productivity gain among all the manufacturing industries. Investment has been expanding rapidly, with a major portion of funds being channeled into research and development. Although the U.S. export share of world markets has been falling, it is still better off than other industries.

Semiconductor makers will have boosted capacity by fifty percent by 1985 even though some are worried about overbuilding. Manufacturing capacity seems to be the only real lid on growth for the industry. Industry shipments of consumer electronics are expected to increase 16 percent this year and should be even higher in 1985. Higher defense spending and a healthier capital investment atmosphere will also tend to make 1985 look strong and boost profits considerably. This year's demand is being fueled by microcomputers, VCRs and other consumer electronics, and military and distributor sales. One reason for the surge is simply the continued trend toward more electronics in all products. Another factor is the personal computer phenomenon which has sparked a strong demand for microprocessors. Although the U.S. export share has been falling in the electrical machinery sector, it is better off than in most other industries.

Transportation Equipment

In the last decade, the transportation equipment industry has experienced slowing growth of output because of the energy revolution and its impaired international competitive position. Production and productivity are considered unstable because of the cyclical vulnerability of its markets. However, a more profitable product mix and internal restructuring during the lean years has spurred the industry's return. As a result, 1985 should be a strong year for transportation equipment. The industry, especially the motor vehicle component, is now devoting a large share of its revenue to research and development expenditures. In the case of the auto industry, this includes modernizing the product; in the aircraft industry, advanced technology is required to develop improved missiles for defense purposes.

Since 1978, the U.S. automotive industry has demonstrated its ability to adapt to altered market conditions. It has completely transformed its vehicle lines through record high levels of capital spending accompanied by massive cash flow deficits. Reduction in unit labor costs, inventory costs and supplier-related costs have brought costs of production under control. Productivity has improved through the use of innovative management techniques and increased use of robotics. Improving general economic conditions will allow the motor vehicles manufacturers to continue plant modernization and new product programs. The ability to raise investment funds for continued capital improvements will remain an important ingredient in responding to import competition and in achieving long-term reductions in production costs. Next year will see a slowdown in the long-run growth of automotive demand as the industry approaches full capacity.

Truck sales have soared, benefiting from a renewed interest in capital investments and straining the industry's capacity to produce. Next year will see a slower growth market in trucks as international competition in the medium and heavy duty truck market intensifies. Some firming of prices late last year should help profits improve even more in 1985. As a consequence, the four largest trucking firms reported profit gains averaging 48 percent in 1983. But, it may still be another two years before the industry as a whole begins to approach the income levels of 1978—the most recent boom year for truckers. Total car and truck sales should top 13.6 million units this year, a 15 percent increase from last year.

Instruments

The instruments industry, consisting principally of scientific and industrial measurement equipment and consumer products such as cameras, continues to be one of the more profitable manufacturing industries. Although both product shipments (in constant dollars) and employment dipped four percent in 1983, some improvement is expected this year and next. The industry is spending more heavily on research and development. One noticeable trend that is emerging is the increasing integration of computer technology with instrumentation. Given the proliferation of small computers in the market for instrumentation, this trend will continue for the foreseeable future.

A host of negative factors continue to dampen the prospects for industry exports: the high value of the dollar, the continued economic sluggishness in other industrialized countries, the serious liquidity problems that have reduced capital expenditures in developing nations' markets, and the increasing competitiveness of Japanese and European manufacturers. Nevertheless, the U.S. continues to be a major net exporter of instruments.

Food and Products

Changing consumer tastes literally dictate changes in the food industry. And last year's trend toward upward mobility, variety and nutrition continues to dominate the fortunes of the food industry. The industry is based on the nation's highly productive agriculture and is a strong participant in the world markets. The continuing strength of the U.S. dollar, however, inhibited exports of processed foods, feeds and beverages, while favorable exchange rates aided foreign producers, who increased their exports in 1983 and will continue to do so throughout 1985. Consequently, sales and profits for many U.S. food and beverage firms have been depressed and will continue to be marginal throughout 1985. The industry also suffers from protectionist measures abroad, including the aggressive measures by the European Economic Community to promote its agriculture.

In a suddenly deflationary environment, food processors no longer find it easy to protect margins by raising prices as consumers are now buying "value" only. Earnings were mixed within the industry: profits of cereal, cake-mix and cookie makers were cut by heated competition and heavy marketing expenses; dairy food and beverage companies benefited from strong sales; meat processors' earnings were squeezed by low consumer demand and high commodity prices. Productivity shows a trend rate of increase of 3.7 percent, which exceeds the rate of output. As a result, employment has been declining; between 1976 and 1983, employment declined at a 0.6 percent annual rate. Although cost-cutting and manufacturing efficiency have contributed to the industry's current profitability, the bottom line in the future will depend upon how processors address changes in lifestyles and demographics.

Tobacco Products

The tobacco industry is finally beginning to recover from the negative effects of a federal tax increase that went into effect January 1, 1983; the tax raised the price of a pack of cigarettes by about eight cents and reduced unit sales markedly. To minimize the effects of the tax, manufacturers have introduced new products and increased advertising and promotion. In 1983, tobacco production manufacturers reduced their work force by 4.6 percent due to decreased demand. However, wages continued to increase above the economy-wide average.

Intensifying competition will characterize the tobacco industry in 1985 as firms, reeling from tax-related consumption declines, seek to gain larger market shares. The improving economy and strengthening of disposable income will aid in minimizing volume losses. The continuing strength of the U.S. dollar and the weaker recoveries abroad will severely limit export sales of manufactured tobacco products. In 1983, the value of all tobacco product exports declined by almost twenty percent compared to 1982. Even though cigarette consumption is expected to increase in 1985, production will be down due to weak export demand.

Textile and Apparel Products

Stimulated by an improving economy, tax reductions, and lower interest rates, the textile industry recovered modestly in 1983. Faced with continued weak demand, textile producers were reluctant to rebuild inventories to normal levels. By the fourth quarter of 1983, textile companies were enjoying a stronger position as demand for cotton yarns, blended fabrics and household furnishings were on the rise.

Nearly all textile companies have invested heavily in automated factories to replace aging, inefficient plants. Organizational restructuring has given textile and apparel makers a better definition of their business lines but investment has been on a downward trend due to increased import penetration. Although textile industry employment declined in 1983 by more than two percent, productivity improvements of over five percent are expected this year and next. The high rate of productivity gain achieved by this industry, in spite of modest gains in output, reflects the efforts that have been made by the industry in recent years to become more efficient through the introduction of new technology and equipment.

The apparel industry plays a major role in the U.S. economy, providing manufacturing activity and employment in every state. Competition in this industry is intense because of the large number of producers both here and abroad. As a result, apparel prices have not increased as fast as those of other consumer items. Employment has declined significantly, falling by 12 percent since 1979. Apparel sales are expected to grow by ten percent this year and seven percent next year.

Textile and apparel imports continue to flood U.S. markets. In dollar terms, imports increased 18 percent last year while exports dropped 14 percent. The bilateral textile agreements under the Multi-fiber Arrangement with Hong Kong, South Korea and Taiwan failed to hold down the surge of imports, partly because of the rapid growth in categories where there are no quotas. The Republic of China has recently gained a role under the Arrangement and is likely to be another aggressive exporter to U.S. markets. No full recovery for this industry is possible with such an onslaught from abroad.

Paper and Products

Because the demand for wood pulp is tied so closely to general economic conditions, both in the U.S. and worldwide, the slower recoveries of foreign economies in 1983 dampened the expected rebound of U.S. pulp mills. The paper industry has been one of the few manufacturing industries to show an increasing share of the country's total investment. The outlook for 1984 and 1985 is for continued growth in production, coupled with improved prices. Higher capacity utilization rates (91 percent in 1983), along with cost reduction measures employed during the recession, point toward a more favorable cost structure. Rising demand and prices, coupled with modest cost increases should boost earnings as much as sixty percent this year and forty percent next year. Given the moderate growth in foreign economies, the relative strength of the dollar may prove to be an important factor for the industry in 1985.

The paper and board industry is basically sound and healthy. The demand for writing grades of paper, the industry's largest dollar segment, has received an important boost from the increased use of personal computers, PC printers, and their thick companion how-to manuals. However, uncertainties do exist about future growth in both domestic and foreign markets. Inroads by plastics into the domestic paper market continues, as witnessed by the growth of plastic in the grocery sack market. Other market losses may arise from the increasing use of telecommunication devices that transmit information electronically. In order to remain healthy, the industry may be forced to intensify its exploration of innovative cost-saving production techniques that will allow its products to compete with alternative materials and be overwhelmingly competitive in foreign markets.

Although the industry is essentially geared to satisfying the demands of the large domestic market, exports also play an important role. The U.S. is a major world supplier of paper products and exports account for about 20 percent of the industry's total production. Historically, however, the U.S. has been a net importer, mainly because of its heavy reliance on imported newsprint and wood pulp from Canada.

Printing and Publishing

The U.S. Printing, Publishing and Allied Industry is the world's largest of its kind. It employs more than 1.3

million people and is the largest conglomeration of small businesses in the domestic manufacturing sector. Between 1976 and 1983, employment grew at a 2.6 percent annual rate, accompanied by an output increase of 3.2 percent. Growth of this industry is predicated upon population growth, higher educational attainment, increased personal consumption expenditures and an expanding GNP. In view of the favorable outlook for these demographic and economic factors, the industry can be expected to continue growing at an average rate of about 3.5 percent throughout the remainder of this year and next. The industry has been relatively profitable as demand for its output is aided by the "information" revolution. Several big publishers posted double-digit gains in earnings in 1983 and expect profit margins to remain unchanged in 1984. Publishers will probably face increases next year stemming from higher prices of newsprint, ink and other materials.

Both exports and imports of printed matter have been rising at a consistent rate for several years. Canada continues to be the major market for U.S. printed products, accounting for fifty percent of the total dollar volume. The primary supplier of U.S. imports of printed products in 1983 was the United Kingdom, with Canada responsible for the second largest share. Because of the size of the U.S. market, the cultural leadership which the U.S. exercises globally, as well as the transfer of technology through the print medium, the printing and publishing industry is a net exporter.

Chemicals and Products

As economies overseas improve, and with an expected boost from agricultural markets, the chemical industry is expected to out-perform most others in 1984 and 1985. The chemical industry has traditionally been the fastest growing manufacturing industry in terms of output, capital spending and productivity. It also devotes a large proportion of its resources to research and development. With strong productivity increases and production slowdowns, the growth in employment has tapered off. Employment increased slowly at a 0.1 percent annual rate between 1976 and 1983.

Thanks to a much stronger cash flow and stringent cost-cutting measures, the debt position of the major chemical companies is much improved. This year and next appears to be promising for chemical manufacturers as they benefit from strong demand in housing, automobiles and textiles as well as higher operating rates and stable petrochemical costs. Total sales could grow by 15 percent over the 1983 level, and profits are expected to increase by 25 percent. The reason for this turnaround is simple: during the 1982 recession chemical companies were forced to institute severe cost-cutting programs—plants were closed, overhead slashed, and employment pruned. These moves lowered the companies' break-even points and the plants are now operating at 75 percent of capacity and earnings are on the rise. Capital spending is expected to increase this year by 15 percent, with the bulk of the money earmarked for modernization and efficiency improvements.

Caution is still needed as considerable overcapacity of some chemicals persists in the domestic market. The industrial sector, especially steel, to which some chemical firms are closely tied, was slow to recover. Sales to the agricultural sector remained low throughout most of the year. Nor did the energy sector provide much spark. Growth in the industry's usually robust export markets has also slowed. Exports are expected to increase only six percent this year while imports might climb over eight percent. Part of the problem lies in the strength of the dollar. The chemical product groups with the best export potential this year and next are synthetic rubber, man-made fibers, medicinals and botanicals, and some of the fertilizer materials. The importation of autos, consumer electronics, and apparel represents a loss of markets for U.S. plastics, textile fibers and numerous other chemical materials. In addition, Kuwait, Canada and Mexico all have been expanding their organic chemicals capacity and are rapidly becoming strong competitors in world markets.

Petroleum Products

The petroleum products industry is expected to experience slow growth, increased production complexity, and limited profits during the next few years. During the 1974-82 period, the industry recorded the second largest rate of decrease in productivity among the manufacturing industries (2.1 percent), accompanied by a 1.7 percent rate of decline in output. The process of adjusting to changes brought about by the rapid escalation of crude oil prices during the 1970s is still underway. Substantial investments are being made to upgrade the industry in response to increasing demand for lighter, refined products. Because of current overcapacity and depressed demand, refiners are competing heavily for a share of the market.

Companies continue to restructure and streamline operations to adjust to long-term, critical changes in the marketplace. Energy conservation is probably the single most important factor affecting the financial fortunes of oil companies today. Some substitution of non-oil fuels combined with excess capacity in the industry combined to exert strong downward pressures on crude oil and petroleum prices this year, which, in turn, held back the industry's growth. Merger fever has been rekindled as firms realize it is cheaper to increase crude-oil reserves via acquisitions than to engage in costly exploration and drilling. Oil companies expect that the five year decline in demand will hardly be reversed in 1985, but crude prices should hold steady or even decline, through next year. Net oil imports, at their 12-year low in 1983, should rise 18 percent this year before flattening out in 1985.

The outlook for natural gas is also bleak. Gas deliveries could rise by about five percent this year but the supply surplus will continue to hang over the market. The coal industry can also expect some bad lumps. Although U.S. coal consumption is expected to rise seven percent from its depressed 1983 level, projected consumption will fall short of 1981 levels. Exports will suffer from a strong dollar. The electric utilities industry is also plagued by problems. Power generation will grow this year at a four percent rate but much of the 1984 gain in electricity output will come from new nuclear plants. As these costly facilities come on line, rates are expected to rise, on average, by ten percent, and overcapacity will probably continue to mount.

Rubber Products

The synthetic rubber industry has been profoundly affected by the rapid increase in the prices of crude oil and other fuels. These price increases have resulted in a declining demand for synthetic rubber as automobiles have become lighter and are using smaller and longer lasting radial tires. The desire to conserve energy and to lower costs also extends to the energy-intensive manufacturing process of synthetic rubber. Prospects for the rubber industry will continue to be influenced by the automotive markets and by substitution. There has been a long-term shift away from rubber towards plastics products because many are less expensive than rubber to process. More than sixty percent of the synthetic rubber produced is consumed in the manufacture of tires and other rubber products for motor vehicles; therefore, 1984 and 1985 sales depend largely on new car production. A slimmer industry will have to run at close to capacity to meet the expected demand for new tires this year and next. Even though replacement sales will probably remain flat, demand from the automakers will be the highest in five years. Improvement in new truck sales will also add to the list of growing demand for tires.

Aided by big gains at Goodyear Tire and Rubber and B.F. Goodrich, industry profits climbed sharply. Record tire sales, near capacity operations, and improved productivity helped the last quarter's earnings. Between 1976 and 1983, employment rose at an annual rate of 1.7 percent while output increased at a 4.3 percent annual rate. Although tire demand remains strong, pricing continues to be troublesome in tires and plastics. Imported tires and intense competition are preventing producers from realizing the profits that would be expected when plants are running at capacity. Both imports and exports will be up this year and next due to improving economic conditions; the exports-to-shipments ratio should be near 15 percent.

Leather and Products

The U.S. is one of the principal suppliers of leather to world markets, yet this industry is a classic illustration that, with today's low transportation costs, the availability of the raw material at home is not a decisive advantage. Imports of leather and leather products continue to hold a large share of the U.S. market. The two major sectors—nonrubber footwear and leather tanning—accounted for 76 percent of the total current dollar value of the industry's shipments in 1983. The developing countries share of total U.S. imports of leather and leather products was over seventy percent in 1983, an estimated $3.5 billion. By comparison, U.S. exports of leather and leather products were only $401 million in 1983, down 14 percent from 1982. Most of the leather products industries are highly labor-intensive and the lower wage rates in developing countries give those suppliers a substantial cost advantage. The strength of the U.S. dollar increases this advantage by making imports cheaper than domestic products.

Leather shipments are expected to decline in 1984 and 1985 as domestic production falls off. Between 1976 and 1983, employment declined at an annual rate of 3.0 percent, accompanied by an output decline of 2.6 percent. Prices of leather imports will continue to be highly competitive because of the strong dollar and subsidized raw material costs in several developing countries. Although the footwear industry consumed about sixty percent of all leather produced domestically in 1983, domestic footwear production declined. Consumption declines of leather were also registered by the handbag, luggage and personal leather goods industry.

CONCLUSION

This industrial recovery has been stronger than average. However, a common factor affecting all our major industries is intense competition from foreign producers in both domestic and international markets. Indeed, given this loss of markets to foreign competition, it is surprising that the industrial recovery has been so strong and widespread. Intervention in foreign exchange markets and increased protectionism will not provide the type of long lasting solutions required for this problem. Public policy should be geared towards increasing incentives to maintain a high level of productivity-enhancing investment. Increased capital spending will not only raise productivity but will also create further investment opportunities, making more new jobs available, thereby improving the overall performance of the American economy. In addition, rising capital outlays will contribute to increased technological innovation, inasmuch as these investments find their way into research and development projects.

TRENDS IN COMMERCE NOTES ON TABLE II

November 1984

Gross National Product (GNP) - The Department of Commerce preliminary estimate for economic activity in the third quarter of 1984 indicates that GNP—the value of the nation's output of goods and services—grew at an inflation-adjusted 2.7 percent annual rate. The third quarter growth rate is a significant slowdown from the the first half of 1984 when GNP was growing at an 8.6 percent annual rate. This lower growth rate reflects a 0.2 percent growth in personal consumption expenditures compared to a 7.9 percent rate of growth in the second quarter. Government purchases increased by eight percent. Business fixed investment grew at an eight percent annual rate while residential investment increased at a three percent annual rate. Inventory investment was the strongest performer in the third quarter as many firms were surprised at the summer collapse in retail sales. This was in sharp contrast to the second quarter when inventories were in the process of being liquidated.

Money Supply - The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased at a 0.5 percent rate in September. This brought the money supply growth, for the last three months, to a 2.1 percent annual rate, below the Federal Reserve target. Between April and June, the money supply increased at an annual rate of more than 12 percent, after remaining relatively stable between March and April. The money supply has been sluggish since June.

Employment - Civilian employment—as measured by the monthly survey of households—increased by 270,000 persons (seasonally adjusted), in September to 105.2 million, bringing the number of employed persons for the first nine months of the year to 2.4 million. The September increase ended two months of declining employment. The survey of business establishments, published by the Department of Labor, appeared to be at odds with the household survey, claiming a loss of over half-a-million jobs between June and September while the establishment data indicated that American businesses hired over one-half million new workers during the summer months.

The U.S. economy has created 6.5 million new jobs since the end of the recession in December 1982. The civilian unemployment rate plunged to 7.1 percent in June, the lowest level since April 1980, but rose to 7.5 percent in July and August and once again declined to 7.4 percent in September, where it has remained for the past two months. The widespread nature of the recovery is best exhibited by the fact that during the last 12 months, 75.4 percent of the 185 private nonagricultural industries in the Bureau of Labor Statistics survey registered increases in employment. The continued strength of the current economic expansion is best exemplified by the fact that last month over 65 percent of the 185 industries surveyed showed increases in employment, the largest percent increase since March.

Prices - The Consumer Price Index for all urban consumers (CPI-U) rose 0.4 percent in September, following a 0.5 percent rise in August. The smaller increase in September was due to a decline in food prices which had surged ahead 0.6 percent in August. This was due, in large part, to a 13.2 percent increase in fresh fruit and vegetable prices. The consumer price index has increased at an annual rate of 3.9 percent in the last six months and 4.2 percent from its year-ago level.

Wholesale prices of finished goods declined 0.2 percent in September, following a 0.1 percent decline in August. The index has remained unchanged for six months. The September decline was largely due to decreases in food and energy prices at the consumer level. Finished energy goods prices, which are lagged one month, declined 0.8 percent in September, the fourth consecutive decline. Prices for finished energy goods in September were 7.4 percent below their levels of a year earlier. Wholesale prices for finished goods have now increased 1.6 percent from year-ago levels and may well end up this year showing the smallest increase in two decades.

The more volatile part of the Producer Price Index, crude goods, declined 0.1 percent in September following a 1.2 percent decline in August. Crude materials prices have now declined in six of the first nine months of 1984 and were actually 0.5 percent below their levels of a year ago.

Housing Starts - Privately-owned housing units rebounded in September and were started at an annual rate of 1,676,000 in August, 8.9 percent above the revised 1,539,000 annual rate reported earlier. The August rate of housing starts was the lowest level since the economic recovery began in December 1982. September's housing starts were almost identical to their level a year ago. In the first nine months of 1984, 1,370,200 housing units were started compared to 1,299,500 for the same period in 1983—an increase of five percent.

Industrial Production - Industrial production declined 0.6 percent in September, following a revised gain of only 0.1 percent in August. This places industrial production 7.8 percent higher than a year ago and over 22.4 percent above the November 1982 recession trough. Business equipment production rose 0.3 percent in September, following increases of 1.5 percent in August and 2.3 percent in July. Production of defense-related goods increased by one percent while consumer goods were manufactured at a one percent slower pace than reported in August. In the consumer sector, a decrease of one million in the number of auto assemblies to an annual rate of 6.9 million units was the result of the General Motors strike and a tight supply of parts of adequate quality. This was also a major contributor to the decline in industrial output for the month. Auto makers had planned to increase auto assemblies back to the 7.9 million rate in October, but that will probably not occur due to the strike at General Motors in Canada. That strike has resulted in layoffs and slowed production at the company's American plants due to parts shortages.

The capacity utilization rate for manufacturing, mining, and utilities declined 0.7 percentage points in September to 81.9 percent matching the decline in industrial production. The rate of capacity utilization in the summer months was at the highest level in four years. Capacity utilization is up significantly from the 69.6 percent rate hit at the bottom of the recession, but remains considerably below the previous peak of 87.3 percent reached in March 1979. Capacity in the third quarter continued to grow as American industry added 0.7 percent to its output capability. This was 2.4 percent above the ability of the American economy to produce goods just one year ago.

Business Costs and Productivity - Private business sector productivity, as measured by output per manhour of all people, increased at a 2.7 percent annual rate in 1983. Productivity continued its climb in the first half of the year as output per hour rose at a four percent annual rate in each quarter. Second-quarter unit labor costs were up 1.3 percent over their year-ago level, but were actually 0.2 percent below their first-quarter rate. Unit labor costs were held down by the increase in productivity which offset increased compensation costs.

Interest Rates - The prime rate, after remaining stable at 13 percent since late June, fell to 12 percent in October. It now appears that the prime rate, which has lagged other interest rates, could continue to go lower. Five year Treasury securities are down almost one and one-half percentage points from their level in early July, while AAA corporate bonds are down 1.2 percentage points. Business loan demand eased at the end of September and was virtually unchanged from its level at the end of August. Since June, business loans at large commercial banks have increased at a 0.7 percent annual rate, a sharp deceleration from the 23 percent growth rate in the first half of the year.

Business Failures and Formations - Dun and Bradstreet's Index of Business Failures for early October indicates that business failures were below the level of October 1983. The latest available data indicates that there were more than 215,000 new business incorporations in the first four months of 1984, a 10.7 percent increase over the same four month period in 1983. If new incorporations continue to increase at the present pace, there should be in excess of 650,000 new incorporations in 1984. The increase in new business incorporations reflects the continued, widespread strength and optimism in the economy. It also signals a continued rise in employment since new business is our greatest single source of jobs.

Federal Spending - The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, indicates that federal spending declined 1.2 percent in September . Federal receipts for FY 1984, which ended September 30, increased 11 percent from FY 1983, while outlays rose by 5.7 percent, less than half the rate of increase in receipts. This has resulted in a $20 billion decline in the deficit for FY 1984, compared to a year ago. The slowdown in the growth of outlays is partly due to the large declines in unemployment benefits. It can also be attributed to a steep decline in farm subsidies due to the PIK program and adverse weather conditions which reduced farm surpluses.

Personal Savings - According to Department of Commerce data, personal savings rose to 6.3 percent of after-tax income in the third quarter, compared to 5.7 percent in the second quarter and five percent in third quarter of 1983. The savings rate for the first nine months of 1984 was six percent, one percentage point above the average 1983 level. In the latest quarter, consumers have been diverting two out every five dollars in increased income into savings. Personal saving in 1984 should be about $35 billion higher than it was in 1983.

Retail Sales - Retail sales increased 1.6 percent in September following declines in July and August, leaving retail sales for the quarter 0.7 percent below their level of the second quarter. September sales were nine percent above year-ago levels, before taking into account price changes. This would indicate that retailers, after taking into account inflation, are selling about five percent more merchandise this year than they were a year ago. The September back-to-school sales pick up has made retailers optimistic about gains for the Christmas season.

Trade Deficit - The trade deficit on a goods and services basis increased to an annual rate of over $85 billion in the third quarter. This was over five times the trade deficit registered in the third quarter of last year. The deteriorating international trade position of the U.S. is best exhibited by the fact that the deficit for goods and services in 1983 was $8.3 billion for the year, following surpluses of $19 billion in 1982 and $28 billion in 1981. The 1984 trade deficit is estimated to be about $75 billion. The deterioration in our balance of payments situation is a result of record breaking merchandise trade deficits which are running at $130 billion in 1984, and are partially offset by surplus in the services sector.

What's Ahead - The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.4 percent in September. The September increase followed three months of decline for this closely watched barometer of future economic activity. A further decline in the leading indicators would have been interpreted by many forecasters as a certain sign of an imminent slowdown in the economy. The three months of decline followed a record breaking 21 consecutive months of increases. The previous record was a 17 month period from March 1975 to July 1976 when the indicator had an unbroken string of gains.

American Workers Achieve High Productivity

American workers, along with American business have been greatly criticised for not being productive. According to their critics, they are no match for workers in other nations, such as Japan and West Germany. However, when one measures the output of each worker as a percentage of the nation's gross domestic product (the total value of all production that takes place within the nation), American workers, as a group, are the most productive in the world. The accompanying chart compares output per worker in seven OECD countries.

Based on the purchasing power of each worker's production, an American worker produces between six percent and 51.5 percent more than his counterpart in other major free-market economies. During the 1977-1980 period, productivity in the U.S. actually declined while that of other major industrial countries continued to increase, narrowing the output gap. However, since the current recovery began in the fourth quarter of 1982, productivity in the U.S. has increased by over five percent, surpassing the cummulative increase in U.S. worker productivity in the six previous years.

The challenge ahead appears to be whether American workers can continue to maintain their lead in out-producing workers in other countries. The current economic recovery shows that we are indeed supplying our workers with the necessary equipment to maintain and increase their productivity level. Investment during the current recovery has grown faster than in any other recovery since the end of the World War II. Much of the credit for this goes to the tax changes enacted by the Economic Recovery Tax Act of 1981 which provided incentives for work, savings and investment while slowing the growth of the share of income taken by government.

GROSS DOMESTIC PRODUCT PER EMPLOYED PERSON (1983)

United States = 100

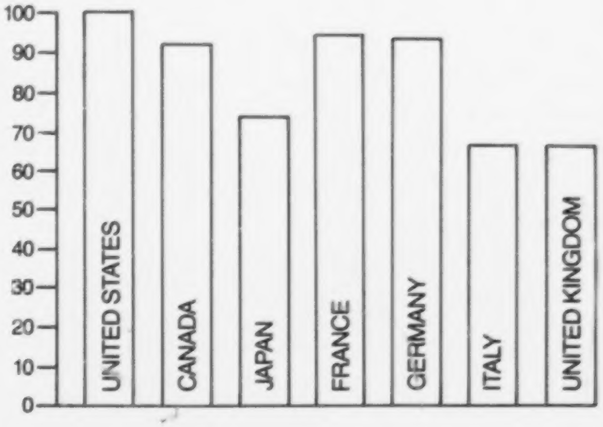


Chart by U.S. Chamber of Commerce
Data from U.S. Department of Labor

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Aug/84	237.1	236.8	234.9	0.1	0.9
Gross National Product ($B) [a]	III/84	3,701.2	3,644.7	3,346.6	1.6	10.6
Gross National Product (72$B) [a]	III/84	1,649.6	1,638.8	1,550.2	0.7	6.4
Money Supply (M1) ($B) [a]	Sep/84	549.0	546.3	518.9	0.5	5.8
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Sep/84	2,381.3	2,347.8	2,192.4	1.4	8.6
Personal Consumption Expenditures (72$B) [a]	Aug/84	1,058.5	1,064.8	1,014.8	-0.6	4.3
Disposable Personal Income ($B) [a]	Sep/84	2,624.6	2,602.8	2,386.1	0.8	10.0
Disposable Personal Income (72$) [a]	Aug/84	1,173.4	1,172.9	1,100.8	0.0	6.6
Personal Savings Rate (%)	Aug/84	6.3	6.1	5.0	0.2[b]	1.3[b]
Civilian Employment (millions) [a]	Oct/84	105.6	105.2	102.0	0.4	3.5
Civilian Unemployment Rate (%) [a]	Oct/84	7.4	7.4	8.7	0.0[b]	-1.3[b]
Average Hourly Earnings (77=100) [a]	Sep/84	161.7	160.6	156.2	0.7	3.5
Consumer Price Index (All Urban, 67=1.0)	Sep/84	3.1	3.1	3.0	0.4	4.2
Purchasing Power of the Dollar	Sep/84	0.3	0.3	0.3	-0.4	-4.0
Prime Interest Rate (%)	Oct/84	12.0	13.0	11.0	-1.0[b]	1.0[b]
Retail Sales ($) [a]	Sep/84	108.5	106.8	99.5	1.6	9.0
BUSINESS PROFITS AND OUPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	II/84	246.0	243.3	198.2	1.1	24.1
After Tax	II/84	150.2	150.6	123.4	-0.3	21.7
Industrial Production (67=100) [a]	Sep/84	165.1	166.1	153.8	-0.6	7.3
Capacity Utilization Rate (Mfg.) (%)	Sep.84	82.1	82.8	78.4	-0.7[b]	2.7[b]
New Housing Starts (thou units) [a]	Sep/84	1,676.0	1,539.0	1,679.0	8.9	-0.2
Net Business Formation (67=100)	Aug/84	117.9	115.3	114.4	2.3	3.1
New Business Incorporations (Thousands) [a]	Apr/84	53.9	53.4	48.9	1.0	10.3
BUSINESS COST						
Unit Labor Costs (nonfarm) (77=100) [a]	III/84	159.1	157.6	155.9	1.0	2.1
Unit Nonlabor Costs (77=100) [a]	II/84	152.3	152.5	151.7	-0.1	0.4
Producer Price Indices (67=100)						
Crude Materials [a]	Sep/84	327.0	327.2	328.8	-0.1	-0.5
Intermediate Goods [a]	Sep/84	320.1	320.5	315.3	-0.1	1.5
Finished Goods [a]	Sep/84	291.4	291.9	286.6	-0.2	1.7
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100) [a]	Sep/84	521.0	530.8	469.1	-1.8	11.1
Fed. Gov't Debt Outstanding ($B)	Jun/84	1,517.2	1,501.7	1,324.3	1.0	14.6
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	III/84	375.5	362.4	342.0	3.6	9.8
Imports of Goods & Services ($B) [a]	III/84	461.0	421.1	358.4	9.5	28.6
Balance on Goods & Services ($B) [a]	III/84	-85.5	-58.7	-16.4	45.7	421.3
WHAT'S AHEAD?						
Index of Leading Indicators (67=100)	Aug/84	164.5	163.7	158.9	0.5	3.5

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States
December 1984

THE HIGH GROWTH SCENARIO IS INDEED POSSIBLE

by Richard W. Rahn and Graciela Testa-Ortiz

In the October issue of ECONOMIC OUTLOOK we presented the Chamber's high growth scenario which showed how the national economy could move towards a balanced federal budget by the end of this decade. Our scenario asserts that, given the structural and cyclical changes which have already taken place in the U.S. economy, the right policy mix would propel the United States to a high economic growth path which would not only return the federal budget to balance, but would significantly enhance the quality of life for all Americans.

As background, let us review the path of the recovery so far (see Table 1). Using the past six recoveries as a guide (excluding the 1980-1981 recovery which only lasted twelve months), we can make several noteworthy comparisons between this expansion and previous cycles. Real gross national product has, so far, risen by 11.6 percent, on a par with the average experience. Media reports notwithstanding, the data show that this has not been a typical recovery fueled by high levels of government and consumer spending. While real consumer spending has increased at a rate consistent with past experience, its contribution to the increase in real GNP has not been impressive. More importantly, however, the rate of increase in federal government spending has been significantly below average, belying the notion that fiscal stimulus was responsible for the recovery's strength. Private investment, on the other hand, has risen at rates twice as fast as previous experience and almost three times faster than real GNP. This expansion, and the accompanying increases in employment and personal income, was generated in the private sector of the U.S. economy as lowered tax burdens on businesses unleashed a capital spending boom of unforeseen proportions.

TABLE 1
BUSINESS CYCLES
FIRST SEVEN QUARTERS OF EXPANSION
(percent change from trough)

Date	Real GNP	Real Fixed Investment	Real Consumption	Real Government Spending	Manufacturing Productivity
49:4-51:3	19.8%	12.5%	5.6%	84.2%	7.2%
54:2-56:1	9.7	15.0	10.1	-10.3	4.9
58:2-60:1	10.6	20.3	8.1	-4.6	8.8
61:1-62:4	9.5	12.8	7.9	11.5	10.3
70:4-72:3	10.0	18.9	10.0	-6.0	10.1
75:3-77:2	9.4	23.2	9.2	2.1	3.4
Average	11.5	17.1	8.5	12.8	7.5
82:4-84:3	11.6	32.4	9.0	2.1	9.1
% of GNP	100.0	279.3	77.6	18.1	NA
% of Avg.	100.9	189.5	105.9	16.4	121.3

NA: Not applicable.

Source: U.S. Chamber of Commerce, Forecast Section.

It is this increase in capital spending which sets the stage for high levels of economic activity in the years to come. Capital investment has not only increased in dollar terms, but also in quality. Competitive pressures, both domestic (as a result of deregulation) and international, have contributed to a major restructuring of the manufacturing sector resulting in a more efficient use of available capital and a stronger than average rise in manufacturing productivity. This, in turn, has in-

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creased the nation's productive capacity, making it possible to achieve rates of economic growth surpassing the economy's perceived potential, while at the same time being a major contributor to the moderate inflation environment we are now enjoying.

This is exactly the result which we had anticipated. For the past two years, we, at the U.S. Chamber, have been going against the popular wisdom in insisting that the 1981 Economic Recovery Tax Act had laid the basis for a strong, long-lived, noninflationary recovery based on strong productivity and investment growth. These results have proven conclusively that the U.S. economy is capable of the kind of growth for which we were branded as "too optimistic" when we predicted it in the past. Given that these higher than average improvements in manufacturing productivity and investment have already been achieved, we believe that policies can be enacted to ensure that the remainder of the 1980s become years of prosperity similar to the decade of the 1960s.

The purpose of our high growth simulation is to demonstrate how this outcome might come about, and to show that such growth can contribute to significant reductions in the deficit. Our scenario shows real gross national product growing by 47.2 percent between 1980 and 1989, compared to 47.5 percent in the 1960s. The relationship between GNP and its components would remain approximately the same as it has been during the past two years. That is, fixed investment is expected to grow two and one-half times faster than GNP, while consumer and government spending rise by only about three-fourths of the increase in real GNP (see Table 2).

TABLE 2
U.S. Chamber of Commerce
High Growth Projections
(percent change)

	1980-1989
Real GNP	47.2%
Fixed Investment	112.2
Residential	72.4
Nonresidential	123.4
Consumption	40.9
Government Purchases	38.0
Nonfarm, Business Productivity	30.4
Implicit GNP Deflator	54.1
3-month Treasury Bill Rate (%)	8.7[a]
Unified Budget Deficit ($B)	
FY 1989	-21.7
CY 1989	-3.0

[a] Ten year average.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Section, using the Data Resources, Inc. long term, quarterly model of the U.S. economy.

The Congressional Budget Office, on the other hand, is forecasting a decade-long increase in real GNP of only 30.7 percent. In our view, this forecast is overly pessimistic. Not only is it significantly below the experience of the 1960s, it is also lower than anything we have experienced in the past three decades (see Table 3). Given the dramatic changes that the economy has undergone, we see no evidence to support their view.

TABLE 3
COMPARISON OF REAL GNP INCREASES
(percent change)

	Real GNP
1950-1959	35.0%
1960-1969	47.5
1970-1979	36.3
1980-1989	
U.S. Chamber of Commerce[p]	47.2
Congressional Budget Office[f]	30.7
Office of Management & Budget[f]	35.9

[p] Projection.
[f] Forecast.

Source: U.S. Chamber of Commerce, Forecast Section.

This issue of the ECONOMIC OUTLOOK is devoted to an analysis of the policies which will make possible the attainment of the high growth goal. Our agenda for a vibrant economy emphasizes the major policy issues facing our country; namely, tax, spending and monetary policy, deregulation, privatization of government services, and free trade. The articles that follow concentrate on three of these six issues; namely, deregulation, privatization and federal government spending. The January issue of the OUTLOOK will address the remaining three key points.

This Month's Forecast

As we stated last month, we view the third and fourth quarters as a period of transition and expect 1985 to show a resurgence in economic activity. The third quarter numbers show the effects of continued large increases in imports and a pause in consumer spending. In fact, had there been no change in net exports from the second quarter; measured GNP would have increased by about six percent rather more than the 1.9 percent actually recorded.

Dr. Richard W. Rahn, Vice President and Chief Economist.
Dr. Ronald D. Utt, Deputy Chief Economist.
Ms. Graciela Testa-Ortiz, Director, Forecast Section.
Mr. Martin Lefkowitz, Director, Economic Trends and Statistics.
Dr. William Orzechowski, Director of Federal Budget Policy.
Ms. Rajni Bonnie Ohri, Economist.

TABLE I

UNITED STATES ECONOMIC OUTLOOK 1983-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS							YEARS			
	Actual		Forecast					Actual	Forecast		
	84:2	84:3	84:4	85:1	85:2	85:3	85:4	1983	1984	1985	1986
GROSS NATIONAL PRODUCT											
Real GNP	7.1	1.9	3.0	4.6	5.0	5.9	5.8	3.7	6.8	4.4	5.1
Consumption	7.9	0.6	4.4	4.3	4.3	4.4	3.9	4.8	5.3	4.1	3.8
Residential Investment	1.3	-4.5	-8.2	6.0	7.4	13.7	11.1	41.7	12.0	3.0	5.3
Business Fixed Investment	21.4	15.8	14.1	14.8	13.4	13.8	13.9	2.5	20.5	14.7	13.7
Equipment	21.2	19.6	14.6	15.1	14.0	14.6	14.8	7.3	22.3	15.6	14.7
Structures	21.3	7.0	13.0	13.9	11.8	11.5	11.6	-7.8	16.0	12.4	11.0
Exports	-0.6	8.8	8.5	6.5	9.5	8.1	11.5	-5.6	5.5	7.8	10.2
Imports	8.1	55.4	12.4	9.0	6.8	7.0	5.6	7.6	30.7	13.4	6.3
Government Purchases	18.6	6.4	7.5	1.9	3.0	2.8	1.1	-0.3	3.7	4.7	1.0
Inventory Change ($ B)	50.6	68.5	50.9	48.6	44.1	46.3	50.7	-13.5	61.0	47.4	56.0
New Car Sales (mil. units)	10.7	10.3	11.0	11.1	11.2	11.4	11.5	9.2	10.6	11.3	11.8
Housing Starts (mil. units)	1.9	1.7	1.6	1.7	1.8	1.8	1.9	1.7	1.8	1.8	1.9
EMPLOYMENT, WAGES AND PRICES											
Unemployment Rate (%)	7.5	7.5	7.4	7.2	7.1	6.9	6.7	9.6	7.5	7.0	6.4
Compensation	3.7	3.6	4.1	6.5	5.4	5.7	6.6	4.8	4.2	5.2	6.8
Productivity	5.4	-0.7	2.0	2.4	3.1	2.9	2.6	3.4	2.9	2.4	2.5
Unit Labor Costs	-1.8	4.3	1.8	4.0	2.3	2.7	3.9	1.3	1.3	2.7	4.1
Consumer Prices	3.7	3.6	4.4	2.8	3.1	3.7	4.3	3.2	4.3	3.5	4.5
GNP Deflator	3.3	3.7	3.7	3.8	2.5	2.7	4.0	3.8	3.8	3.4	4.1
Prime Interest Rate (%)	12.3	13.0	11.4	10.5	10.0	9.7	9.3	9.8	12.0	9.9	9.5
Profits from Current Production ($ B)*	195.2	197.1	200.4	208.3	214.7	218.9	218.9	149.4	194.3	215.2	218.3
GOVERNMENT FISCAL POLICY ($BILLION)**											
Unified Budget—Receipts								601	667	756	830
Unified Budget—Outlays								796	842	940	1003
Unified Budget—Federal Surplus or Deficit								-195	-175	-184	-173

*Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revised estimates of the national income and product accounts for the third quarter. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates, which becomes effective in 1985, and the Tax Reform Act of 1984. No additional fiscal policy assumptions are made. We assume that real defense spending grows by approximately five percent between 1985 and 1986, and that real nondefense discretionary spending is held in check. Monetary policy is expected to continue in its current conservative stance. The money supply, as measured by M1, is expected to grow at about the mid-point of its range. Crude oil spot prices have shown continued weakness despite OPEC's efforts to shore up prices through production cuts, therefore, this forecast assumes that the OPEC marker price of a barrel of oil is cut by $1.50 by year-end. The price of imported crude oil then remains at about $27.50 per barrel through 1986. A return to a normal harvest is expected next year so that wholesale farm prices will remain low. The federal minimum wage is assumed to remain at $3.35 an hour through the forecast period. Sustained growth in foreign markets and partial exchange rate correction foster an acceleration in real export gains and slowdown in real import growth.

Amidst the generally lackluster economic news of the past few weeks, several encouraging notes emerge. The major good news item is the November decline in the civilian unemployment rate to 7.2 percent from 7.4 percent in September and October. Business investment remained strong in the third quarter continuing to post double-digit gains, and interest rates have eased substantially. Domestic automobile sales are inching their way back to the eight million unit level experienced prior to the General Motors strike, confirming that demand remains strong. According to our retail sales survey, expectations for the Christmas retail season remain healthy, seventy percent of the respondents expect retail sales this month to be higher than they were a year ago. Finally, despite the recent lackluster performance of new housing starts, we anticipate that the easing in mortgage interest rates will provide a second wind to the housing market. A recent HUD report shows that mortgage commitment rates on fixed-rate contracts are almost back to the 13.5 percent level of a year ago, and sales of existing homes held steady in October after five consecutive monthly declines. Coupled with continued high levels of business confidence in the economy's future, aggressive business spending plans, further declines in interest rates, and moderate increases in inflation, the outlook for 1985 and 1986 remains favorable.

Our forecast shows continued weakness in the fourth quarter as inventory build up slows somewhat. Continued easing of interest rates and strong residential and nonresidential investment growth rates should support 1985 and 1986 economic activity at a healthy level. Softness in world oil markets and farm prices, together with improved labor productivity will help keep inflation in check. In the foreign sector, some strengthening in the Western European economies, and a slowly declining dollar should improve U.S. exports. However, import demand is expected to remain strong throughout 1985.

BRINGING THE FEDERAL LEVIATHAN DOWN TO SIZE

by
William Orzechowski

For many, the nation's most pressing economic problem is the federal deficit. However, the remedies that are being put forward to deal with the problem are often worse than the ailment. For example, many claim that the federal budget offers little room for expenditure cuts. Consequently, they embrace tax increases as a necessary component of a deficit reduction package.

However, the experience of other industrialized nations teaches us that tax increases do not solve the problem. Most of the Western European countries, for instance, have attempted to solve their budget deficit with round after round of tax increases. In the process, average taxes have been pushed to a whopping 45 percent of GNP. The result has been slow economic growth, escalating government expenditures, and rising, not falling, deficits.

The failure of tax increases to bring about fiscal responsibility puts the spotlight where it belongs: on the expenditure side of the budget. In the case of the United States, the truth of the matter is that there is plenty of room to reduce federal spending. In fact, it has been estimated that over twenty percent of the federal budget contains inefficient and extravagant programs.

Determining Budget Cuts

The federal budget is composed of thousands of relatively small items which together add up to a problem of massive proportions—a Leviathan of Lilliputs. This makes the job of cutting federal spending difficult since so many different programs have to be scrutinized. What is needed is a method to ferret out inefficient and extravagant programs since we do not want to cut programs for the sake of simply cutting the budget. That is, we do not want to hurt the truly needy or sacrifice important national security objectives. Nonetheless, there are sound economic reasons for reducing many federal programs.

In order to get a handle on these many spending programs, I propose a method to identify inefficient federal programs by scrutinizing them with relation to a hierarchy of four major criteria: program objectives, fiscal relevance, institutional alternatives, and administrative efficiency. Briefly, the objectives test is used to determine whether a program fulfills a genuine public goal by trying to establish if it has genuine public good characteristics, solves externality problems, and/or actually redistributes income. The fiscal relevance test estimates the benefits and costs of a program. The third test focuses on the most efficient institutional arrangements for achieving the program's goals. Finally, the last test determines whether or not the program is managed efficiently.

The intent of many federal programs is to finance the production of goods and services which are difficult to provide through the private sector because it may be difficult to collect contributions from beneficiaries. Unlike a private good, there is no way of excluding "free riders" from sharing in the benefits of public goods. National defense is a good example. It is considered a public good because all citizens benefit from it. If national defense were to be financed totally by the private sector, it would not be possible to collect enough revenues. Those individuals who fail to contribute would still enjoy the national defense provided by the contributors. This problem can find a solution through government financing which forces all citizens to contribute to national defense through taxation.

However, there are many federal programs that do not meet this objectives test since they amount to the finance of private rather than public goods. In other words, they provide goods and services that the private sector could generate without a government subsidy. For example, many commodity price support programs and federal loan subsidies would not meet the objectives test. The commodity price support programs do not solve a public goods problem. Instead, they represent a transfer payment from consumers and taxpayers to farmers. Consumers must purchase farm products at higher than market prices, and taxpayers must pay the government's cost of buying agricultural surplus. Moreover, price supports mean that low income individuals must pay higher prices for basic necessities thereby increasing their dependence upon welfare programs such as food stamps.

In a similar vein, many federal subsidies and loan guarantees merely transfer wealth from the general taxpayer to special producer and consumer groups. These private goods could be financed in their entirety in the marketplace. Further, those private goods that do not generate an adequate market demand should not be produced at all since the resources involved in their production could generate higher value elsewhere. Yet the federal budget is riddled with many such cases. Urban development subsidies have been awarded for projects such as luxury hotels; the Rural Electrification Administration grants loans at five percent interest for rural electricity; and Amtrak lost close to one billion dollars while receiving subsidies that averaged about $40 per passenger.

What is truly amazing is the amount of federal budget cuts that can be made on the basis of the objectives test alone. According to estimates by the Congressional Budget Office (CBO) and the Heritage Foundation, annual savings in excess of $30 billion a year are possible. Moreover, such cuts would not deprive the poor of needed social programs since they often represent subsidies to higher income producer and consumer groups.

After passing the objectives test, the next test would focus on the relevance of a particular program. For example, a program may be associated with a public good or it may help the poor, thereby passing the objectives test, but it could be, nonetheless, irrelevant. This occurs if the benefits of the program do not cover its costs. For instance, a program to arm soldiers with bows and arrows along with their rifles may contribute, by some degree, to increasing national security. However, the benefits of such a program would hardly cover costs. Likewise, the Comprehensive Employment and Training Administration (CETA), was designed to provide job training for low income individuals. While the program had an acceptable objective, it turned out to be a failure because of the small number of people who obtained permanent jobs as a result.

Unlike the objectives test, the relevance test can be difficult to implement since expertise is often required for a careful benefit-cost analysis of programs that are technical in nature. Nevertheless, it is the responsibility of government auditors to discover such waste. In the case of the defense budget alone, annual savings of this nature are estimated to be enormous, in the range of $30 billion to $40 billion annually. The defense budget is replete with many cases of weapons systems that are expensive but ineffective. Yet they remain in the budget because Congress and special interest groups benefit from their existence. This is borne out by the frustration of those technically trained individuals who, after locating such waste, are often ignored, ridiculed, and sometimes demoted.

The third test for screening federal budget programs focuses upon institutional arrangements. A program may achieve a reasonable objective and could be fiscally relevant, but the most effective way of implementing the program may require participation by the private sector or lower levels of government. Public mass transit is a case in point. These systems solve traffic congestion problems that are localized in nature. By placing these activities at lower levels of government, the direct beneficiaries of such programs would be required to finance them. This reduces the incidence of cross-subsidization, that is, the act of taxing the entire population for programs that provide local or regional benefits only. Moreover, locally-funded programs allow for greater competition in the supply of public goods. One such program is the San Diego rail line. It was recently completed ahead of schedule at one-tenth the cost of a similar system funded by the federal government.

There are several variations on the institutions theme, with many of these requiring greater participation by the private sector. Many proposals call for privatization in cases where actual production of the good takes place in the private sector, even though it is financed in the public sector. One important method allowing for public finance but private production is a voucher system. Other methods rely on various forms of contracting-out and an assortment of bureaucratic reform.

Social Security is a classic case of improper institutional arrangement. Most retirees are under the illusion that the benefits they receive are equivalent to a market return on the amount of their past contributions. In reality, however, they are receiving benefits that greatly exceed a market return because vote-seeking politicians have mortgaged the future by continually boosting benefits beyond actuarially sound levels, that is, levels beyond which no private firm would have undertaken the program. The Grace Commission has estimated that today's typical Social Security recipient, over his lifetime, will receive benefits that are four times the total contributions made by him and his employer, plus interest on those contributions. Within two years, he or she receives benefits equivalent to the total of all past contributions. As a consequence, the Social Security system confronts serious long run problems that few politicians are willing to face.

This dilemma could have been avoided through proper institutional arrangements. When Social Security was conceived it strove to achieve reasonable welfare objectives through the installation of a retirement floor. This would benefit less fortunate individuals while at the same time requiring everyone else to put something aside for retirement. This retirement floor should have remained apart from any concept of a *quid pro quo* annuity plan. If welfare and annuity functions were split, individuals would have turned to the private sector for the bulk of their retirement needs. In this way a more responsible and efficient retirement system would have evolved.

Finally, the last test every federal program should pass is an administrative efficiency test. If a federal program has a reasonable objective, is fiscally relevant, and has been privatized and decentralized to an efficient degree, it should also be managed in an efficient manner. Managerial abuses are often the prime focus of budget cutters. Goldplating, overstaffing, contractor scandals, bureaucratic sloth, uncollected debts and obsolete military bases make interesting headlines. The Grace Commission is a testament to the monumental proportions of such waste. It reported over $200 billion in savings that could be achieved in three years by improving administrative functions alone.

In summary, economic principles suggest a rather clear cut method for reducing federal government expenditures. A federal program should meet a legitimate public sector objective, its benefits should cover costs, it should be decentralized to an efficient degree, and it should be managed efficiently.

Room To Cut

Using the criteria developed above, reputable sources such as the Congressional Budget Office, the Government Accounting Office, the Heritage Foundation, the Brookings Institution, the Grace Commission, and the Senate Finance Committee, have located budget cuts that amount to close to $200 billion in one year alone. This is more than twenty percent of the present budget.

A detailed list of these budget cuts has been assembled by Glenn Pascall in his forthcoming book, *The Trillion Dollar Budget—How To Stop The Bankrupting Of America*. Nearly all of the budget cuts suggested by Pascall trim back program waste and extravagance, reduce subsidies for private goods and services, and decentralize federal programs without jeopardizing national security or hurting the truly needy.

In terms of budget categories, approximately $50 billion could be shaved from the defense budget alone. While we all recognize the need to strengthen national defense relative to other budget functions, there is, nonetheless, no need to fund the waste found in the military budget. For example, military commissaries were originally established to provide low cost goods to soldiers in frontier areas. Yet, today we find commissaries in such frontier towns as Norfolk, San Diego, San Francisco, and Washington, D.C. The Grace Commission estimated that in order to make the military retirement system solvent, an annual levy on payroll of 118 percent would be necessary. In the private sector, on the other hand, the levy is 14 percent of payroll. In 1969, the Nixon Administration proposed closing 307 obsolete military bases. Today, fifteen years later, nearly all of them remain in operation. Essentially, most of the defense cuts involve the reduction of weapons systems that are fiscally irrelevant or cost-ineffective, the removal of waste through more competitive procurement procedures, and the disposal of unneeded facilities.

There are vast opportunities for reform in the entitlements area, as well. Proposals for budget cuts spanning Social Security, Medicare, and the Civil Service and Military Retirement systems, can easily add up to over $50 billion in savings. For instance, the Social Security benefit formula can be adjusted to curb some of the program abuses of the past without placing undue hardship on retirees. A one year freeze on cost of living adjustments (COLAs), coupled with a COLA set at sixty percent of the increase in the Consumer Price Index (CPI), can save over $20 billion in 1989 alone. Aside from the savings, this change in the benefit formula would provide a measure of equity to the system, since sixty percent of the CPI is the average cost-of-living increase received on private pensions that are indexed to the CPI. Savings in the Medicare program are made possible through greater co-payments by program beneficiaries who are presently receiving mammoth subsidies for short term hospital stays. Some of the flagrant abuses found in the Civil Service and Military Retirement systems, where unfunded liabilities stand at a colossal one trillion dollars, can be curbed by making them comparable with private pension plans. There is no reason why military and civil service personnel should retire with pensions at the ripe old ages of 40 and 55, respectively, while their private sector counterparts retire with less generous net benefits in their middle sixties.

Finally, over $55 billion in budget cuts are available in other areas of the budget, primarily in the domestic discretionary programs. These cuts run the gamut from repeal of the Davis-Bacon Act and reduction of agricultural price supports, to re-assignment of regional activities to state and local governments. In general, the theme is for a more efficient government through elimination of federal subsidies for private goods and greater fiscal decentralization.

Summary: A Budget Cutting Strategy

Painstaking research by reputable institutions reveals what is common knowledge—the federal budget is severely bloated, and there is plenty of room to cut it further. There is no need for tax increases of any kind. What is needed is the political will on the part of the Administration and Congress to bring about the necessary spending cuts.

In this regard, the U.S. Chamber has taken the lead in developing a federal budget plan that will move the budget towards balance without relying on any tax increases. This federal budget plan will be the cornerstone of a business coalition that includes the Chamber and other major business associations. In this way the business community will be united in a lobbying effort to bring about a significant reduction in the growth of federal expenditures.

The business coalition's federal budget plan will be presented in the format of a modified budget freeze. For the most part, the plan strives to reduce expenditures on a proportionate basis. It bundles many of the budget cuts enumerated above into one large package that is spread across all budget functions. In this way, a lot of cuts are made at once and none sticks out from the rest, thus creating a sense of fair-share sacrifice. No one group can claim that the budget is being balanced on their back. The results are dramatic. With one plan under consideration, the deficit falls to $13 billion by 1989. The effect is all the more surprising when it is realized that this plan uses only a portion of the cuts suggested above.

LIGHTENING THE LOAD OF REGULATION

by
Rajni Bonnie Ohri

Four years ago, the Reagan Administration announced a four part program to revitalize the U.S. economy. Regulatory reform was presented as part of that plan. During 1980, Reagan pointed out that for businessmen faced with a multitude of regulations, the compliance costs are much like a tax. Sweeping regulatory reform was seen as a significant means to stimulate production by reducing costs and improving cash flow in the short run, and to improve productivity in the long run. Recognizing the far-reaching costs of inefficient overregulation, Reagan argued that a government interested in encouraging economic growth ought to impose only those regulations where benefits exceed costs, and ought to administer these necessary regulations as efficiently as possible.

The added costs of regulation have far-reaching effects and are eventually translated into price increases. Automobile safety and emissions control devices added an average of $600 to car prices in 1978. American steelmakers face a competitive disadvantage because compliance with pollution abatement regulations pushes domestic prices up over $8 dollars a ton. Buyers of new homes pay over $2,000 more so builders can meet government construction requirements. Spokesmen for textiles, chemicals, transportation, energy and other industries charge that regulations lower productivity and growth in their industries.

Indeed, Wayne B. Gray, author of *The Impact of OSHA and EPA Regulations on Productivity,* finds that more than one-third of the productivity slowdown in manufacturing industries was the result of increases in government regulations on health, safety, and the environment. Gray estimates that these regulations reduced productivity growth in the manufacturing sector by 0.57 percent annually and lowered manufacturing output in 1978 by $13 billion. He compared the rate of productivity growth in the 1973-78 period to the experience in 1958-69 and found that those industries which spent the most to comply with government regulations introduced after 1970, suffered the largest declines in productivity growth.

The net benefits of deregulation are just beginning to have a lasting impact on the economy. Long-distance airline fares, adjusted for inflation, have declined by almost fifty percent in the last seven years. Many trucking rates have been lowered by thirty percent in real terms since 1980. Between 1982 and 1983, the cost of standard telephones fell by one-third. And, for small investors, the cost of buying stock is sixty percent lower as discount brokerage firms have proliferated.

Early Years of Regulatory Reform

The current regulatory reform movement, which began in the Ford Administration and gathered steam under President Carter, was initially concerned with erecting new institutional constraints on the costs that regulatory decisions imposed on the economy. Both Administrations attempted to tackle regulatory reform by adding on another layer of regulation that replicated the original problems. President Carter expressed his concern regarding regulatory reform by establishing a Regulatory Analysis Review Group, a Regulatory Council, and by issuing Executive Order No. 12044 on Improving Government Regulation, which broadened the requirement for economic impact analyses.

Under the Ford and Carter Administrations, progress towards the deregulation of airlines, trucking, railroads, energy, telecommunications, and banking created the notion that government regulation was entering a declining phase. The facts, however, support the reverse view. In 1977, the Environmental Protection Agency (EPA) imposed by far the heaviest regulatory burden on the economy, accounting for over $2 billion in regulatory costs to the business community. Certain regulations were found to be especially burdensome while others imposed relatively small costs. To illustrate the former, two Acts, the Control of Air Pollution from New Motor Vehicles and the National Ambient Air Quality Standard for Particulates accounted for over $900 million of incremental costs in 1977. The impact of regulation also showed a wide variation among industries. For example, the incremental cost of the Occupational Safety and Health Administration (OSHA) rules averaged $6 per worker per year in the banking industry, but $220 per worker per year in the chemical industry. In several instances, regulations were found to conflict with broad national policy, as seen by EPA regulations which encouraged the increased use of oil, particularly low-sulfur oil, adding to U.S. demand for foreign oil and straining the country's balance of payments.

In addition, these regulatory burdens and others contributed to rising inflation, low productivity growth, and lagging economic growth which characterized the late 1970s. Three quantitative measures of this phenomenon can be cited: Douglas Costle, former administrator of the EPA, figured that his agency's regulations raised the consumer price index in 1978 by about 0.4 percent. Edward Denison of the Brookings Institution, calculated that expenditures on health and safety regulations, environmental protection, and crime prevention resulted in a 20 to 25 percent decline in productivity growth in 1975. And Murray Weidenbaum's study for the Joint Economic Committee estimated that the total cost of regulation was $103 billion in 1979.

Current Regulatory Reform

President Reagan addressed the problem of regulatory reform by creating a Presidential Task Force on Regulatory Relief and charging it with the responsibility for bringing the federal bureaucracy under control. He also established a formal regulatory review process to ensure that federal agencies would not overstep their bounds. The principles the President announced for guiding the Task Force and the agencies are: the federal government should not regulate unless there is demonstrated need; it should ensure that the benefits of regulation exceed the costs; and it should be sure it has chosen the most cost-effective solution that places decision-making authority with the most responsive unit of government.

In reports prepared by the Task Force, the achievements of this Administration make for impressive reading: new rule-making has been cut by one-half; the number of pages in the Federal Register has been reduced by one-third; paperwork for 1981 was cut by 200 million man-hours; $9 billion to $11 billion in one-time investment costs as well as $6 billion in annual recurring costs have been saved.

The Administration has also issued new rules and reviewed existing ones: it has cut back federal intrusion into local decision-making, such as the Department of Education's dress code regulation; it has eliminated red tape, such as the multi-level permit review system; and it has rescinded counter-productive policies, such as the EPA regulations inhibiting the construction of new, cleaner plants. The Task Force has targeted more than one hundred major regulatory programs for review and modification, paying special attention to the regulatory problems of small businesses, local governments and other groups that lack highly paid lobbyists or representatives to tackle the federal bureaucracy. Their efforts have saved state and local governments between $4 billion and $6 billion in total investment costs, and $20 billion in annual costs over the next decade. The actions range from issues such as rescinding the previous administration's multi-billion dollar requirement for bilingual education in schools, to lifting Department of Labor restrictions on home-work in the Vermont textile industry, allowing workers there the choice of staying at home knitting sweaters rather than be obliged to work in a factory.

While the President and his aides certainly deserve praise for what has been accomplished, the job has only just begun. In reaching these accomplishments, the Administration relied primarily on tools that yield only transitory results. Many legislative enactments mandate unrealistic goals or unreasonable methods for social regulation and need to be revised. Such onerous regulation ranges from the "zero discharge" goal of the Clean Water Act to the "zero risk" provision of the Delaney Amendment of the Food, Drug and Cosmetic Act. Thus, if this Administration expects to leave a lasting legacy of true regulatory reform, they must direct their attention during the next four years toward achieving statutory changes in the many laws that provide mandates to the regulatory agencies. The regulatory statutes under which many agencies function were drawn up long before technology and a changed economic environment brought competition to many industries, and they may now require change.

The Regulatory Challenge

The move to deregulate, which began slowly just a decade ago, is gaining force throughout the economy. By reducing government regulation, the nation is revitalizing three basic industries—transportation, finance and telecommunications—and boosting the economy as well. As deregulation takes hold, this segment of the economy is experiencing a burst of competition which is encouraging innovation, increasing productivity, and reducing prices.

Transportation, telecommunications, and the financial system are critical components of the country's infrastructure. To be sure, there are short-term costs from the deregulation of these industries. Airlines, trucking companies, and banks have failed. Adjustment in the airline industry has been hard, including the failure of some major airlines, witness the case of Braniff. The result has been the largest losses in airline history—$1.4 billion from 1980 to 1982. Trucking deregulation, which hit the industry in 1980, has had a harsh impact as well. Price-cutting, the entry into the industry of thousands of new trucking companies, and the 1981-82 recession put more than 300 trucking companies out of business. Rising costs of deposits and keener competition have cut into bank profits, weakening some banks. Seventy banks have failed this year, and regulators have nearly 800 others on the "problem list."

But these costs must be measured against a broader backdrop. For example, 10,000 small new operators have entered the trucking industry, and 14 new airlines have been launched since 1978, when Congress eased entry and granted more pricing and route flexibility. After years of decline, railroads are finally making a healthy rate of return on investment. The financial industry is also treating the public to an explosion of products and services offered by a growing number of new institutions. Deregulation has brought unparalleled opportunities to many companies plus lower costs to consumers. Those lower costs have contributed to the slowdown in the inflation rate and to a pickup in labor productivity.

Labor costs in the deregulated sectors are also being slashed. Although separating the effects of recession is difficult, deregulation is seen as a major contributor to the continued decline in the rate of growth of labor costs, what Marvin Kosters of the American Enterprise Institute calls "disinflation in the labor market." Nowhere is that more evident than in the transportation industry, where both airline and trucking unions have accepted wage cuts and more flexible work rules.

Conclusion

The economic case for reducing government regulation in the marketplace is, of course, different from the political one. Deregulation as a political possibility began to take shape during the Ford Administration, followed by a strong commitment under President Carter. Some gains were made during this Administration's early years as well. Now, however, signs of weakening political will are becoming increasingly evident.

When this Administration took office, a number of strong actions in regulatory reform occurred in its early months. Since then, however, the momentum appears to have been lost. What seemed to be a clear sense of direction has given way to a disappointing drift. Murray Weidenbaum claimed that the objectives of regulatory reform should be to do a better job of achieving regulatory goals while reducing regulatory burdens. For some areas of regulation, the best way to attain these objectives is to dismantle regulatory structures and rely on competition. For other areas, however, some form of regulation is called for. In those cases, agencies should avoid regulations that are either inefficient or too costly compared to the benefits they achieve, while establishing policies to deal more effectively with the problems that gave rise to the regulatory programs in the first place. The goal of regulatory reform is the same in both areas—to achieve improved overall economic efficiency.

PRIVATIZATION OF GOVERNMENT SERVICES: IMPROVED EFFICIENCY AT A LOWER COST

by

*Graciela Testa-Ortiz and Frank Sellers**

Adam Smith's greatest legacy to the development of economic thought was the concept of improved efficiency through specialization and the division of labor.

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Today, we are unlikely to give the division of labor a second thought. Nevertheless, we still have the choice of, for instance, making our own clothing, furniture, household repairs, etc., or having someone else do it for us. In general, however, we find that it is a more efficient use of our resources, including time, to buy someone else's services. In so doing, we usually shop around for the best quality and price.

Similarly, the government, at all levels, has the same choice, namely, to do things for itself, by hiring government employees to perform the necessary functions, or to contract with a private sector supplier of the required goods and services. For example, to maintain the beauty of its parks, a locality can hire and train the necessary personnel, or contract with a local landscaping firm to do the same job. There are two ways of transferring public functions to the private sector. One is through contracting-out, where the work is performed by a private sector firm but the government maintains the ultimate responsibility for overseeing and planning. The other is acquiring the goods and services from the private sector without any actual government involvement in the production process, as for instance, when the government buys paper clips.

The evidence on the private versus public production of services required by all levels of government shows that the private sector can meet many of the needs more efficiently and in a more cost-effective manner than the public sector. The National Oceanic and Atmospheric Administration (NOAA) recently found, for instance, that it could save $1.8 million per year by hiring a private firm to warehouse and mail out nautical and aeronautical charts. NOAA had been spending $2.8 million annually to do the same work with federal workers.

To some observers, the ability of the government to keep abreast of the needs of the country are at question. The remainder of this decade and the decade of the 1990s will be years filled with fast-paced technological change in the private sector, but the federal government is limping along with 1960s technology. The Defense Department cannot keep track of its spare parts inventory and throws away new spare parts at one end of its supply system while it buys the same parts on the other end; the Social Security Administration cannot keep its computer banks up-to-date and needs a total revamping of its system; and other examples keep arising.

Who better is there for the government to turn to in seeking ways to cope with the increasing pressure for up-to-date information and technology than the sector of the economy producing that technology: the private sector? More of the same has put the government where it is today. The direction has to change. The types of activities involved include seeking private sector services for computer software; independent laboratory and testing; research and development; architecture and engineering services through CAD/CAM or computer-assisted design and manufacturing; systems integration and support activities; telecommunications development; accountants, lawyers, food services, etc.

Steve H. Hanke, a former senior economist on the Council of Economic Advisers, testified before the Senate Small Business Committee earlier this year that, *"Excluding postal workers, more than one in every four federal employees is engaged in commercial activities . . . The commercial activities performed by the federal government are very wasteful, and could be performed at a lower cost in the private sector."* Savings have already been realized in situations where there has been a transfer of commercial activities to the private sector. For instance, the Department of Defense has identified $250 million in savings which reoccur annually through the contracting out of 235 activities that were previously undertaken with public sector employees.

There is an important difference, however, in the degree of reliance in the private sector and the savings that could be achieved as a result. A significant amount of contracting-out of small-scale, one-time projects is already taking place. However, this differs significantly from a more total reliance on private initiative, which in some cases would entail the dismantling of legal monopolies currently in existence.

Recent examples of private initiative in areas long viewed as the exclusive domain of the government suggest that privatization opportunities are much greater than previously believed. Private competition with the postal service offers a dramatic example of the savings that could be achieved. Indeed, it is readily apparent that the keen competition between private parcel carriers, such as Federal Express, United Parcel Service, and others, is resulting in improved service and lower costs for consumers. Private electronic mail also offers an alternative to the postal service. However, the postal service remains a legal monopoly, even as the evidence accumulates to show that postal services could be handled more efficiently in the private sector. A recent example is the case of a private postal service in Utah that was charging 15 cents to mail first-class letters. REACT Postal Services Inc. offered consumers the same type of discounts for pre-sorting that are routinely available to businesses. Because most of the letters that consumers send are to pay bills, and these go to a small number of addresses, REACT could combine hundreds of small envelopes into a large package and mail 4,000 bills for $35, whereas the separate postage on individual letters would cost $800.

At the same time that the firm was offering these lower cost services to Utahans, it was making a profit of about 10.8 cents per letter. The American Postal Workers Union brought a suit against REACT charging the company with decreasing Postal Service revenues and undermining the legally protected postal monopoly. Unfortunately for Utah consumers, the suit resulted in an injunction against REACT.

Another area where one would least expect to find private enterprise thriving is corrections facilities, such as jails, halfway houses, and detention centers for juveniles and undocumented aliens. Private companies now operating in several states can not only build a jail, but also administer it, hire and train guards, provide meals and the personnel to run rehabilitation and drug-abuse programs, and even arrange financing for the project. Reports state that private companies can perform these functions at a lower cost than the government—about $10 less per inmate per day—while still showing a profit.

Unfortunately, even as the evidence on the benefits of privatization continues to increase, the federal government has taken some backward steps in major areas where research and innovation are occurring very rapidly in the private sector. It was recently revealed that the Department of Defense is creating its own Software Engineering Institute to develop the necessary computer software for weapons systems.

Urban mass transit provides an example of the costs involved in reversing the trend towards privatization. Whereas in the early post-war years a majority of urban transit operations were privately owned, local governments have increasingly taken on urban mass transit as their exclusive domain. The result has been large, expensive systems, with relatively low ridership rates. Why has this occurred? The preponderance of public transportation systems has afforded transportation workers with a virtual monopoly. As labor costs have risen, the systems have increasingly substituted capital for labor, and reduced the frequency of service. The result has been that instead of buses running a route, say ever ten minutes, we now have larger buses and/or trains running every fifteen or twenty minutes. This inconveniences riders who turn to other transportation methods, reducing revenues even further. Many suburban routes, for instance, could easily be served by private companies using smaller buses. Instead, what we typically see are large, expensive buses with very few riders.

Moving public functions to the private sector not only contributes to reducing the deficit through the savings that would accrue to the government, but also results in higher government revenues, increased productivity, and higher economic growth. When a private firm, rather than public employees, perform a commercial activity, revenues are returned to the states, as well as the Federal Treasury, in the form of taxes (such as social security, unemployment, sales, corporate income, property, and fuel taxes), and user's fees (such as licenses and highway use). The employment of government workers, on the other hand, returns revenues only in the form of social security and unemployment taxes. An Oregon study recently concluded that taxpayers receive a net return of more than 20 percent of the contract cost when construction projects are undertaken in the private sector. While a similar study in New Jersey concluded that a firm of 200 employees and an annual gross income of $10 million in government contracts would return $1.2 million annually in taxes to the three levels of government.

Clearly, the examples shown here only scratch the surface. There remain tremendous opportunities for greater savings from moving many commercial activities currently performed by the federal, state, and local governments, to the private sector.

TRENDS IN COMMERCE NOTES ON TABLE II

December 1984

Gross National Product (GNP) - The Department of Commerce preliminary estimate for economic activity in the third quarter of 1984 indicates that GNP—the value of the nation's output of goods and services—grew at an inflation-adjusted 1.9 percent annual rate, a significant downward revision from the earlier estimate of 2.7 percent growth. The third quarter growth rate is a significant slowdown from the the first half of 1984 when GNP was growing at an 8.6 percent annual rate. The lower third quarter growth rate reflects a 0.6 percent rate of growth in personal consumption expenditures compared to 7.9 percent in the second quarter. Business fixed investment was revised upward and grew at a 15.9 percent annual rate, the fifth consecutive quarter of double digit investment growth. Government purchases increased 6.4 percent and residential investment declined at a 4.6 percent annual rate.

Money Supply - The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—decreased by 0.6 percent in October. This resulted in a 0.1 percent decline in the money supply in the latest three month period. This performance places the nation's money supply well below the target growth range of four percent to eight percent established by the Federal Reserve Board earlier this year, and below the six percent growth target set by the

Federal Open Market Committee at its October 2 meeting. The money supply has been sluggish since June. However, the Fed, in fear of slowing down the economy too fast, has eased up significantly since early September.

Employment - Civilian employment—as measured by the monthly survey of households—jumped by approximately 300,000 persons (seasonally adjusted), in October to 105.9 million, bringing the employment increase for the first nine months of the year to three million. The establishment data indicated that American businesses have hired over one million new workers since June. The U.S. economy has created nearly seven million new jobs since the end of the recession in November 1982. The civilian unemployment rate declined in November to 7.2 percent, from 7.4 percent in September and October.

Prices - The Consumer Price Index for all urban consumers (CPI-U) rose 0.4 percent in October, for the second month in a row. This follows a 0.5 percent increase in August. The October increase was due to a rebound in food prices which had declined in September, and an increase in gasoline prices. Smaller increases were also reported for the apparel and housing industries. The consumer price index has increased at an annual rate of 3.7 percent in the last six months and 4.2 percent from its year-ago level.

Wholesale prices of finished goods declined 0.2 percent in October. This was the third consecutive month of decline for the index which is composed solely of goods, and does not include services which are a part of the consumer price index. The wholesale price index is now 0.2 percent lower than it was six months ago, and only 1.4 percent higher than its year-ago level. The October decline was largely due to declines in the indices for cars and trucks as prices for newly introduced 1985 models were lower, after seasonal adjustment, than the September closeout prices. In contrast, finished energy goods prices turned up after several months of substantial declines. Prices for finished energy goods in October remained 5.6 percent below their levels of a year earlier.

The more volatile part of the Producer Price Index, crude goods, declined 0.9 percent in October following declines in five of the last six months. Crude materials prices have now declined in seven of the first ten months of 1984 and were actually 1.5 percent below their levels of a year ago this October.

Housing Starts - Privately-owned housing units declined in October to their lowest level since December 1982. New housing starts in October reached an annual rate of 1,515,000, ten percent below the revised 1,679,000 annual rate reported in September. October's housing starts were 9.4 percent below their level a year ago. In the first ten months of 1984, 1,522,000 housing units were started compared to 1,458,800 for the same period in 1983—an increase of four percent.

Industrial Production - Industrial production remained unchanged in October following a decline of 0.5 percent in September. This places industrial production 6.6 percent higher than a year ago and over 22.5 percent above the November 1982 recession trough. Business equipment production rose 0.3 percent in October, following a 0.1 percent increase in September. This placed business equipment production 16.9 percent above the level of a year ago, more than double the increase in production for the entire index. Production of defense-related goods increased 0.7 percent in October, the largest increase for any market grouping. Consumer goods were manufactured at a 0.2 percent faster pace than reported in September, largely due to a 0.3 percent increase in the production of nondurable goods which was partly offset by a decline of 0.1 percent in durable goods production. The scheduled rebound in auto assemblies from a strike-depressed annual rate of 6.9 million units did not materialize. This was mainly due to the strike at the General Motors Canadian operation which resulted in a tight supply of parts of adequate quality, and reportedly limited new car assemblies for the month. Auto makers had planned to increase the rate of auto assemblies in October back up to 7.9 million units, the rate at which they had been producing prior to the GM strike.

The capacity utilization rate for manufacturing, mining, and utilities declined 0.2 percentage points in October to 81.8 percent despite the fact that there was no change in industrial production for the month. This appears to indicate a continued rise in capacity. Capacity in the third quarter continued to increase as American industry added 0.7 percent to its output capability. This was 2.4 percent above the ability of the American economy to produce goods just one year ago.

Business Costs and Productivity - Private business sector productivity, as measured by output per manhour of all people, increased at a 2.7 percent annual rate in 1983. Productivity continued its climb in the first half of the year as output per hour rose at a 4.5 percent average annual rate, but slowed to a 0.9 percent annual rate in the third quarter. In the nonfarm business sector productivity fell at a 0.7 percent rate. Manufacturing productivity increased at an eight percent annual rate, indicating a quick pay off on new equipment purchases. In the third-quarter unit labor costs were up 1.6 percent over their year-ago level, but were actually below their first-quarter rate.

Interest Rates - The prime rate, after remaining stable at 13 percent since late June and falling in October to 12 percent, now stands at 11.25 percent. Both short- and long-term interest rates have declined sharply since mid-year. The average decline in short-term rates has been about 190 basis points. In the long-term market, Treasury issues declined about 200 basis points while triple—A corporate bonds were down only about 125 points. Even with these declines rates have generally remained above their January levels. Business loan demand eased at the end of October and was virtually unchanged from its mid-August level. Since July 4th., business loans at large commercial banks have increased at a 2.4 percent annual rate, a sharp deceleration from the 23 percent growth rate experienced during the first half of the year.

Business Failures and Formations - Dun and Bradstreet's Index of Business Failures for October indicates that failures were below the level of October 1983. The business discontinuance index, however, was higher than it was a year ago resulting in more business closures for the month. The latest available data indicates that there were 269,984 new business incorporations in the first five months of 1984, a 9.9 percent increase over the same five month period in 1983. The largest percentage increases in the first five months of 1984 were reported in Georgia, 32.1 percent; Washington, D.C., 31.9 percent; North Dakota, 30.7 percent; Maryland, 28.1 percent; and Virginia, 27 percent. Regionally, the largest percentage increase was reported in New England where new incorporations were up 17.2 percent. If new incorporations continue to increase at the present pace, there should be in excess of 650,000 new incorporations in 1984. This rapid increase in new business incorporations reflects the continued, widespread strength of and optimism in the economy. It also signals a continued rise in employment since new business is our greatest single source of new jobs.

Federal Spending - The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, indicates that federal spending increased 5.1 percent in October, the first month of fiscal 1985. Receipts for the month were up 15.7 percent from the same month a year ago due to large increases in personal income and social insurance taxes. Federal receipts for FY1984, were up 11 percent from FY1983, while outlays rose by 5.7 percent, less than half the rate of increase in receipts. This resulted in a $20 billion drop in the deficit for fiscal 1984 compared to a year ago.

Personal Savings - According to Department of Commerce data, personal savings rose to 6.4 percent of after-tax income in October, as consumers put away all of their income gains for the month. The October savings rate is quite high by recent standards, showing a continued upward trend compared to 6.3 percent in the third quarter and five percent in third quarter of 1983. Personal saving in 1984 should be about $40 billion higher than they were in 1983.

Retail Sales - Retail sales declined 0.1 percent in October, following an increase of 1.2 percent in September. October sales were very disappointing remaining below the level reached in June. October sales were 6.7 percent above year-ago levels, before taking into account price changes. This would indicate that retailers, after taking into account inflation, are selling about three percent more merchandise this year than in 1983. With consumer confidence remaining at relatively high levels, and continued growth in incomes and employment, Christmas retail sales this year should be a pleasant surprise to retailers.

Trade Deficit - The trade deficit on a goods and services basis increased to an annual rate of over $85 billion in the third quarter. This was over five times the trade deficit registered in the third quarter of last year. The deteriorating international trade position of the U.S. is best exhibited by the fact that the deficit for goods and services in 1983 was $8.3 billion for the year, following surpluses of $19 billion in 1982 and $28.0 billion in 1981.

What's Ahead - The composite index of leading indicators, designed to predict future movements in aggregate economic activity, decreased 0.7 percent in October. This follows an upwardly revised 0.6 percent increase in September. The August data was also revised upward turning a previously announced 0.1 percent decline into a 0.1 percent increase. Leading indicators have now declined in three of the last five months, indicating at the very least, a weakening trend in the economy.

U.S. Firms Lead World in Technology Exports

There must be something right going on in American research and development since the rest of the world is pounding at our doors to get the benefits. In 1982, U.S. companies were paid more in royalties to allow foreign firms to use their technology, than were companies in France, the United Kingdom, Japan and Germany combined. This translated into a balance of payments surplus of $6.8 billion from technology exports. The accompanying chart shows the technology exports and imports of the U.S., United Kingdom, France, Germany, and Japan.

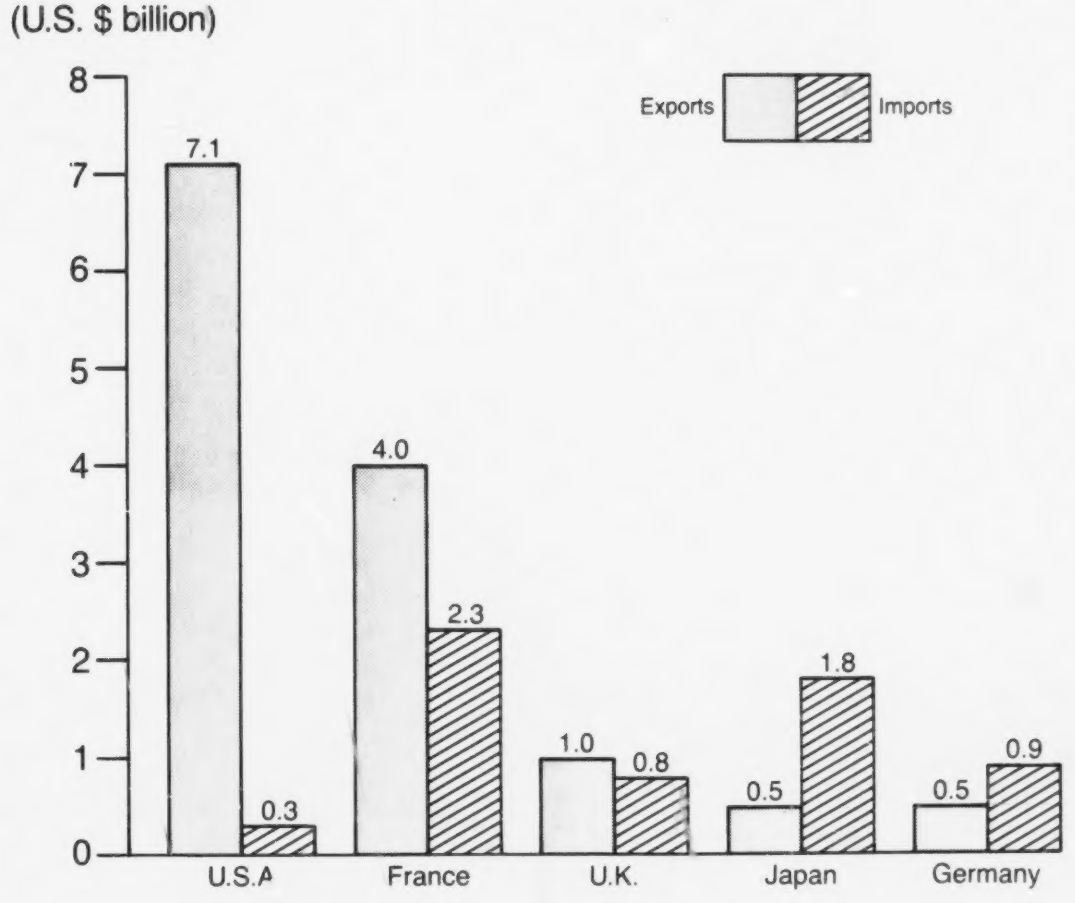
TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Sep/84	237.3	237.1	235.1	0.1	0.9
Gross National Product ($B) [a]	III/84	3,695.2	3,644.7	3,346.6	1.4	10.4
Gross National Product (72$B) [a]	III/84	1,646.5	1,638.8	1,550.2	0.5	6.2
Money Supply (M1) ($B) [a]	Oct/84	545.5	548.9	521.7	-0.6	4.6
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Oct/84	2,386.2	2,387.9	2,216.6	-0.1	7.7
Personal Consumption Expenditures (72$B) [a]	Sep/84	1,073.9	1,058.2	1,016.7	1.5	5.6
Disposable Personal Income ($B) [a]	Oct/84	2,640.1	2,624.8	2,410.3	0.6	9.5
Disposable Personal Income (72$) [a]	Sep/84	1,180.0	1,174.4	1,106.4	0.5	6.7
Personal Savings Rate (%)	Oct/84	6.4	5.9	5.2	0.5[b]	1.2[b]
Civilian Unemployment Rate (%) [a]	Nov/84	7.2	7.4	8.8	-0.2[b]	-1.6[b]
Average Hourly Earnings [a]	Oct/84	$8.40	$8.41	$8.13	-0.1	3.3
Consumer Price Index (All Urban, 67=100)	Oct/84	315.3	314.5	302.6	0.4	4.2
Purchasing Power of the Dollar (67=$1.00)	Oct/84	0.318	0.319	0.331	—	—
Prime Interest Rate (%) Nov. 29	Oct/84	11.25	12.0	11.0	-0.75[b]	.25[b]
Retail Sales (billions $) [a]	Oct/84	107.7	107.9	100.9	-0.1	6.7
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	III/84	223.7	246.0	227.4	-9.1	-1.6
After Tax	III/84	139.3	150.2	142.6	-7.3	-2.3
Industrial Production (67=100) [a]	Oct/84	165.2	165.2	155.0	0.0	6.6
Capacity Utilization Rate (Mfg.) (%)	Oct/84	82.1	82.2	78.9	-0.1[b]	+3.2[b]
New Housing Starts (thou. units) [a]	Oct/84	1,515.0	1,679.0	1,672.0	-9.8	-9.4
Net Business Formation (67=100)	Sep/84	120.8	119.4	115.8	1.2	4.3
New Business Incorporations (thousands) [a]	May/84	51.2	53.9	50.2	-5.1	1.9
BUSINESS COST						
Unit Labor Costs (nonfarm) (77=100) [a]	III/84	159.4	157.6	155.9	1.1	2.2
Unit Nonlabor Costs (77=100) [a]	III/84	157.8	156.8	149.4	0.6	5.6
Producer Price Indices (67=100)						
Crude Materials [a]	Oct/84	324.0	327.0	329.2	-0.9	-1.6
Intermediate Goods [a]	Oct/84	320.5	320.1	316.2	0.1	1.4
Finished Goods [a]	Oct/84	290.9	291.4	287.1	-0.2	1.3
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100) [a]	Oct/84	568.5	540.9	491.6	5.1	15.6
Fed. Gov't Debt Outstanding ($B)	Jun/84	1,517.2	1,501.7	1,324.3	1.0	14.6
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	III/84	369.3	362.4	342.0	1.9	8.0
Imports of Goods & Services ($B) [a]	III/84	459.2	421.1	358.4	9.0	28.1
Balance on Goods & Services ($B) [a]	III/84	-89.9	-58.7	-16.4	53.2	448.2
WHAT'S AHEAD?						
Index of Leading Indicators (67=100)	Sep/84	163.8	165.0	162.4	-0.7	0.9

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

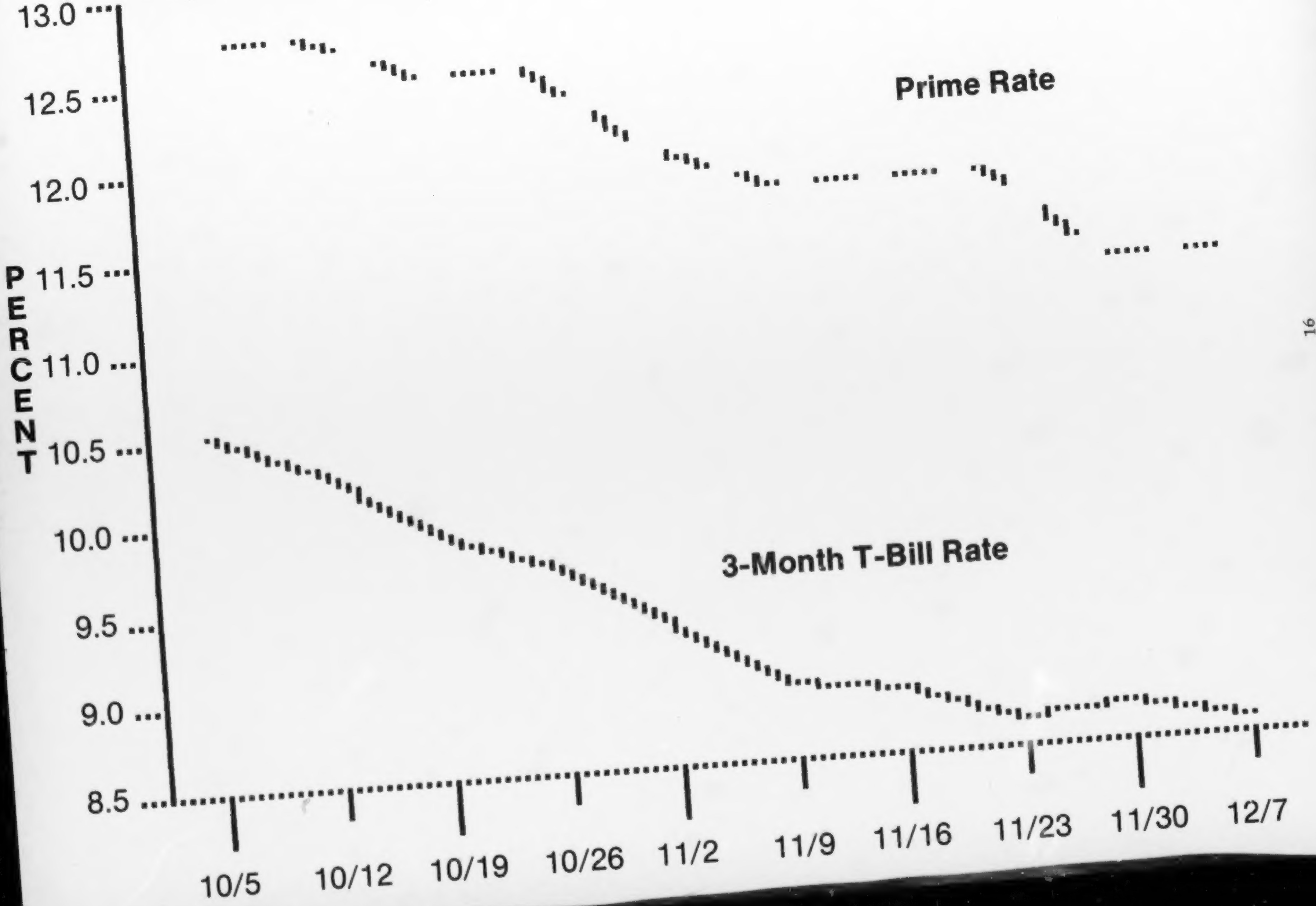
EXPORTS AND IMPORTS OF TECHNOLOGY IN MAJOR DEVELOPED COUNTRIES

(1982)



U.S. Chamber of Commerce

RECENT INTEREST RATE TRENDS



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E C O N O M I C
OUTLOOK

Chamber of Commerce of the United States
January/February 1985

POLICY CERTAINTY WOULD MAKE THE CRYSTAL BALL CLEARER

by
Richard W. Rahn

As the old adage has it, "the only thing certain about an economic forecast is that it will be *wrong*. The only question is, in which direction, and by how much." Over the last couple of years, the supply-side economists, and in particular, the U.S. Chamber, have been less wrong than most other forecasters. During the same period, the major econometric models fared even more poorly than the consensus forecast. Using the latest GNP revisions and the forecasts reported in the December 1982 and December 1983 issues of *Blue Chip Economic Indicators*, the following table summarizes recent forecasting records.

We attribute our superb forecasting performance to the fact that we believe that policies largely determine outcomes, and that incentives are important. In our forecasts for 1983 and 1984, we incorporated our views that the fiscal policy changes which became effective under the 1981 Economic Recovery and Tax Act (ERTA) would have a tremendous beneficial impact on investment incentives. In addition, we felt that the positive effect of lower marginal tax rates in increasing investment and work effort would largely offset the negative implications of the prevailing high deficits and real interest rates. We added these judgemental elements into the usual quantitative analysis and emerged with forecasts which have consistently placed us on the optimistic end of the range, but which also proved to be more correct than most. In fact, as the table above shows, we erred by not being optimistic enough!

As you will note in the article that follows, our forecast continues to be considerably more optimistic than the consensus. Despite our optimism, however, we believe that the economy will not reach its potential because of sub-optimal policies by the Fed, the Congress, and the Administration. Thus, over the next few months, we will continue to describe and advocate policy changes that could make our high growth scenario (see the October and December issues of ECONOMIC OUTLOOK), a reality.

COMPARISON OF FORECASTING RECORDS FOR 1983 AND 1984

REAL GNP
(1983 & 1984)

	Dec. 1982 for 1983	Dec. 1983 for 1984
Actual Outcome	3.7%	6.8%
U.S. Chamber of Commerce	3.1%	6.1%
error(a)	-0.6	-0.7
Consensus Forecast	2.8%	5.4%
error(a)	-0.9	-1.4
Average of Major Econometric Models	2.2%	5.2%
error(a)	-1.5	-1.6

(a) Percentage point difference between forecast and actual outcome. A negative error denotes an underestimate.

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1985:
THE YEAR OF THE OX

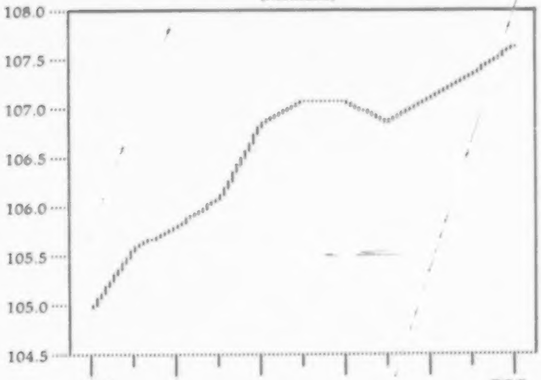
by

Ronald D. Utt and Graciela Testa-Ortiz

According to the Chinese calendar, 1985 is the year of the ox. Although we are used to describing markets as either bulls or bears, the ox may be the more appropriate characterization for 1985. Following one and half years of above average vigor, the U.S. economy shows all signs of having settled into a sustainable period of strong, healthy growth. Like the ox, the economy has become an extremely tractable animal.

Following the usual rumblings of impending doom and stagnation from the usual claque of forecasters during the last half of the year, 1984 ended on a very positive note. While the small uptick in the December unemployment rate was expected due to problems with seasonal factors, the 341,000 new jobs created in the nonfarm sector reflect the continued strength of the U.S. economy. Chart 1 shows that, except for a lull in the middle of the year, nonfarm employment rose sharply in 1984. Disposable income rose in tandem with it, growing by 7.3 percent in 1983 and 10.2 percent in 1984. Since consumer price increases averaged only four percent last year, the improvement in nominal income translated into a 6.8 percent real increase. The continuing slide in interest rates, combined with increases in employment and real disposable income, have resulted in a very optimistic American consumer. A recent Gallup Poll noted that 61 percent of the Americans surveyed thought that 1985 would be a "better" year than 1984. Gallup concluded that the "U.S. optimism is due in considerable measure to the public's bullish views about the economy."

CHART 1
Total Nonfarm Employment
During 1984
(Millions)



This optimism was reflected in personal consumption expenditures which, as Chart 2 shows, rose significantly during 1984. Excluding food and gasoline outlets, retail sales rose by one percent in December, and the respondents to the Chamber's retail sales survey noted that the Christmas selling season was quite good. Domestic car sales ended 1984 with a strong surge, averaging 8.3 million units in December compared to 6.9 million and 7.1 million in October and November, respectively (see Chart 3). As we anticipated, the decline in interest rates continues, with the prime rate falling to 10.5 percent in mid-January. New housing starts, reacting to the decline in interest rates, began to recover.

CHART 2
Personal Consumption Expenditures
During 1984
(Billions of Dollars)

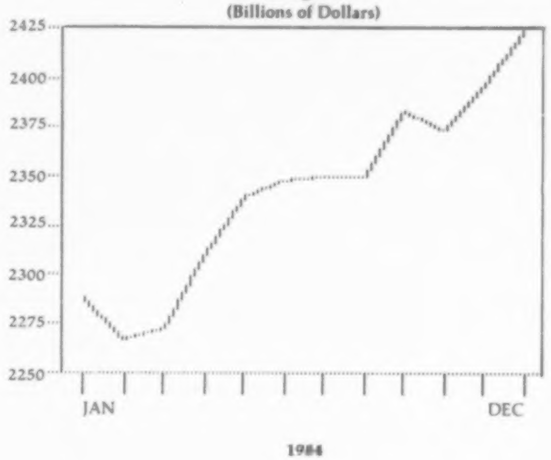
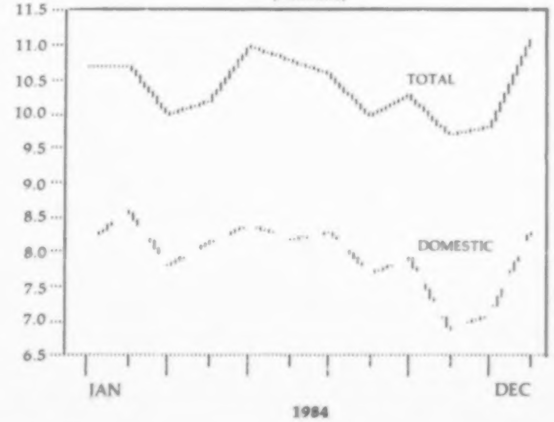


CHART 3
New Car Sales
During 1984
(Millions)



Dr. Richard W. Rahn, Vice President and Chief Economist.
Dr. Ronald D. Utt, Deputy Chief Economist.
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Mr. Martin Lefkowitz, Director, Economic Trends and Statistics.
Dr. William Orzechowski, Director of Federal Budget Policy.
Ms. Rajni Bonnie Ohri, Economist.

This high level of confidence by the consumer was reflected in total output, as the index of industrial production rose 0.6 percent in December. And, in spite of the lackluster performance of overall real GNP during the last half of the year, business fixed investment continued to grow at double-digit annual rates. Finally, the news on the inflation front remains encouraging. Producer prices for finished good rose by only 1.8 percent in the past twelve months, and the general price level (the implicit deflator for GNP) rose by 3.7 percent.

Reflecting our continued optimism, this month's forecast is similar to last month's—1985 will be a year of above average growth. Since we did not downgrade our anticipations for 1985 and 1986 as a result of the third quarter's weakness, there is no need to upgrade it, now that it is becoming apparent that the third quarter's lull did not signal the beginning of a trend. Real GNP is expected to grow by 4.6 percent in 1985 and 5.1 percent in 1986; quarterly growth rates are forecast to remain close to an annual rate of five percent this year and next. Spurred by continued declines in interest rates, the investment sector, both residential and nonresidential, is anticipated to remain the driving force in the nation's economy. A partial exchange rate adjustment and increased strength in our major trading partners can be expected to support a rise in real exports in 1986.

Financial Factors and Investment

One key factor that leads us to be optimistic about the 1985 outlook is the dramatic declines in interest rates since late summer. Perhaps finally reflecting the Federal Reserve's resolve to maintain price stability and the likelihood that monetary conditions would soon be eased, all market interest rates peaked in mid-summer and went into free-fall beginning in September. By late January, the 90-day Treasury bill rate fell to 7.68 percent, the lowest rate in two years.

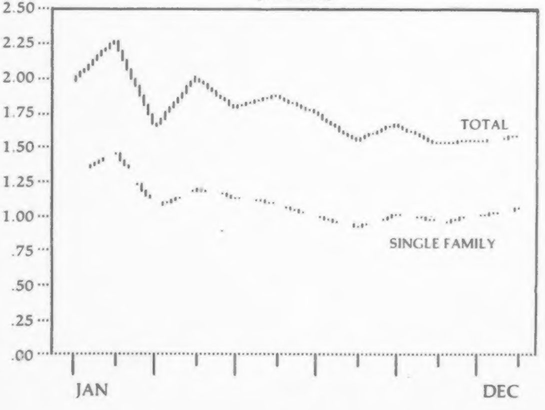
In addition to the effects of a more accommodative monetary policy and greatly diminished inflationary expectations, the increased availability of funds also contributed to the decline in interest rates. In 1984, the personal savings rate jumped to 6.1 percent of disposable income, up from just five percent in the preceding year. This amounted to an additional $39 billion in savings as consumers curbed their spending and finally increased their savings in response to higher incomes and tax incentives. Corporate profits, another important source of national savings, also increased significantly during the year. Data for the third quarter of 1984, the most recent available, indicates that profits were running $43 billion ahead of the same quarter a year ago.

By way of comparison, the magnitude of the interest rate decline closely matched the sharp fall in interest rates that occurred in late 1982 and preceded the powerful recovery which emerged in early 1983. Because of these sharply lower rates, we have every reason to believe that early 1985 could see a similar pick-up in economic activity as lower rates stimulate interest-sensitive sectors such as automobiles, housing, and business fixed investment.

Mortgage interest rates, which peaked last July at 14.85 percent, fell steadily through the year and reached 13.34 percent by early December, the lowest these rates had been since February, 1984. As a result, residential housing reversed the decline that began in mid-1984 and with mortgage rates projected to fall further, housing starts should rise to 1.9 million by the end of the year. This would imply an 18.8 percent gain from current levels of production. This forecast, however, is contingent upon there being no significant changes in tax law as it affects real estate investment.

Single family starts tracked the ups and downs of interest rates fairly closely but with about a three month delay. Reaching their peak during the first quarter, starts fell sharply during the year before bottoming out in August and October (see Chart 4). Since then, steady but moderate gains have been made which should accelerate in 1985 in response to lower mortgage rates and increased availability of funds from traditional mortgage lenders. Multifamily starts (apartments and condominiums) have continued to fall through the year, reaching their low point in December, but we are optimistic that they, too, will rise. However, it is possible that uncertainty regarding tax law as it affects commercial real estate, and a relatively high vacancy rate could depress activity in this important area.

CHART 4
New Housing Starts
During 1984
(Millions)



1984

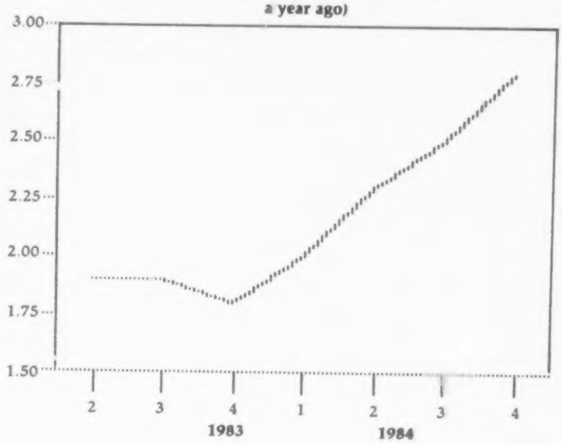
Nonresidential business fixed investment should also respond favorably to the decline in interest rates and sustain what, so far, has been the strongest capital spending boom of the postwar era. Although business investment spending in 1984 grew at the fastest rate in thirty-eight years, it also showed weakness toward the end of 1984, recording an 11.1 percent gain at an annual rate in the fourth quarter compared to increases in excess of twenty percent for the first half of the year. As in the case of residential housing, business fixed investment closely tracked interest rates with a delay of three to six months. Triple-A corporate bond rates, which peaked in late June at 13.71 percent, have fallen steadily during the year to about 12.2 percent at present. This is as low as they have been since late 1983 and the first two months of 1984. As a result, double-digit rates of growth in capital spending should continue during 1985. Factors other than a more favorable interest rate climate that will help support strong rates of capital spending growth include high levels of corporate cash flow and the pressing need for American business to maintain rapid productivity growth to meet the challenge of aggressive foreign competition.

For most analysts and forecasters, the decline in interest rates was totally unexpected. In the July, 1984 issue of *Blue Chip Financial Forecasts,* a monthly compendium of interest rate projections by prominent forecasters, 32 of the 40 participants believed that the prime rate in the fourth quarter of 1984 would be 13 percent or greater. Instead, it averaged 11.8 percent and reached a low of 10.75 percent in the final week of the year. With short-term money rates still falling, we expect further declines in the prime rate over the next few months and estimate that it will go as low as 9.3 percent by the end of 1985. Regular readers will remember that the Chamber's Forecast Center has consistently taken the minority view that rates would fall by the end of 1984 and, happily, again called the turn in this important indicator. And, as has so often been the case, the actual outcome was considerably more optimistic than even we had guessed.

Inflation, Capacity Utilization and Productivity

We have just completed a second year of very low inflation compared to the experience of the past decade and all signs point to a continuation of that trend during this year and next. Thanks to moderate rises in wages and relatively strong productivity gains, unit labor cost increases were held down to 1.3 percent in 1983 and 1.4 percent in 1984. Stronger wage pressures, as unemployment continues to subside, are expected to push the growth rate of employee compensation up during this year and next, but continued productivity improvements, averaging 2.4 percent in 1985 and three percent in 1986, will offset their impact on labor costs. Capacity utilization remains well below the level that might be expected to contribute to bottlenecks and shortages, and ultimately, to increased price pressures. In fact, as Chart 5 shows, the nation's industrial capacity has risen steadily since mid-1983. At the end of 1984 the Federal Reserve Board's index of capacity was 2.8 percent higher than its level at the end of 1983.

CHART 5
Federal Reserve Board's
Index of Capacity
(percent change from the same period, a year ago)

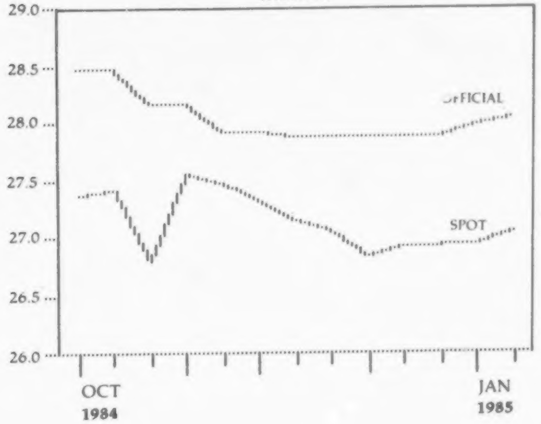


Crude oil prices, a major contributor to the inflation of the 1970s, can only be expected to continue easing in the foreseeable future. OPEC has been generally unsuccessful in shoring up prices through production cuts. Further, there is every reason to believe that whatever discipline existed within OPEC has effectively disappeared, particularly in light of the fact that some OPEC member countries, such as Nigeria, are in serious straits with regard to their foreign debt situation, and can ill afford production cutbacks that will erode their foreign exchange earnings.

OPEC's predicament is compounded by the recent announcement by Norway and Britain that they would allow market forces to determine the price of North Sea oil. This only implies further easing in the price of this grade of crude which competes directly with Nigerian oil. Another ominous note, as far as OPEC's ability to control world oil prices is concerned, is the recent pronouncement by the head of the Mexican oil agency. In the past, Mexico, while not an OPEC member, has been sympathetic to the organization. However, Mexico now feels that if OPEC cannot discipline its own members regarding production quotas, there is no reason for it to continue to go tacitly along with OPEC goals—the obvious implication being that Mexico may be planning to increase oil production.

Even the weather has, once again, refused to come to the aid of the oil producing nations. The severe winter buffeting the Northern Hemisphere may be too little, too late, as far as increased oil demand is concerned. As a result, any safe bet on the course of oil prices during the next two years should reasonably be on the downside. This month's forecast assumes that the price of imported crude oil will fall to about $25 a barrel by this summer and remain in that vicinity through 1986. This is not as drastic an assumption as it might appear at first glance, since the differential between the average official price and the spot market price of OPEC oil has averaged $1 per barrel since early October. As of the 21st of December, the spot market price for a barrel of OPEC oil stood at $26.77, and had strengthened to only $27.06 by the week of January 11th, in spite of the severity of the winter weather (see Chart 6).

CHART 6
Official Vs. Spot Market Price
For OPEC Oil
($/barrel)



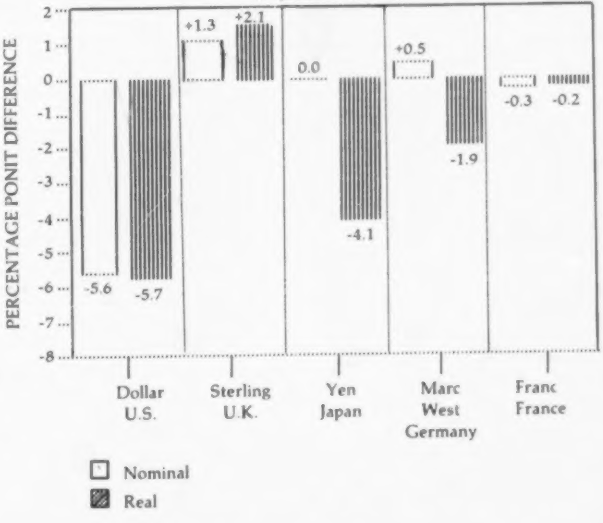
The only negative on the inflation front stems from the impact of a possible decline in the value of the dollar, which we are assuming will take place. As a general rule of thumb, a ten percent decline in the dollar's value is associated with a one percentage point increase in consumer prices (other things being equal), as imported goods become more expensive. Our forecast foresees a rate of increase in consumer prices of 3.3 percent in 1985 and 3.6 percent in 1986, the rise being explained by a partial adjustment in the dollar's exchange rate, but tempered by falling commodity prices, particularly oil.

Exports, Imports and the U.S. Dollar

The refusal of the dollar to decline in value in the face of the yawning U.S. trade gap has stumped analysts who have been predicting such a decline for the past three years. In hindsight, it is easy to see why the American dollar remains in strong demand even though, from a trade point of view, the excess of imports (supply of dollars) over exports (demand for dollars) should have placed downward pressure on the dollar's value. In the past, part of the explanation stemmed from the interest rate differential between the dollar and other international currencies; the higher return of dollar-denominated assets prompted investors to demand more dollars, raising its price. The sharper decline in U.S. inflation *vis-a-vis* foreign rates of inflation also raised the real interest rate differential.

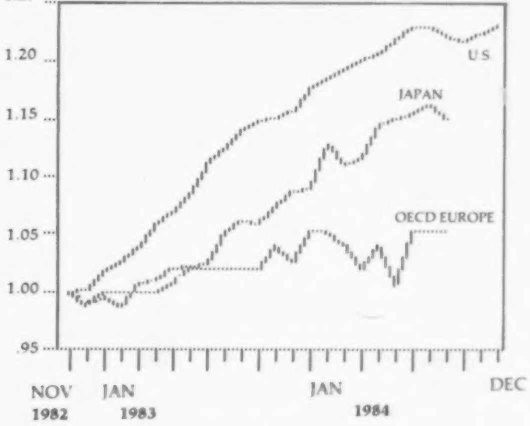
However, the dollar remained strong, even as U.S. interest rates fell and foreign interest rates rose. Between early September and mid-January, the three month Eurodollar rate fell by 556 basis points. By way of comparison, the Canadian Eurodollar rate fell by 253 basis points and the Eurofranc rate eased by just 28 basis points. All other major Eurocurrency rates actually rose, with the Eurosterling rate rising by 132 basis points. Adjusting the Eurocurrency rates for changes in inflation yields the same results in terms of likely pressures on the dollar. The decline in the real Eurodollar rate during this period was 566 basis points. With the exception of the real Eurosterling rate, which *rose* by 212 basis points, all other rates fell significantly less than the real Eurodollar rate (see Chart 7). However, during this same period, far from easing, the trade weighted exchange value of the U.S. dollar rose by 7.5 percent.

CHART 7
Movements In Selected Eurocurrency Rates
On 3-Month Deposits
(Sept./84 to Jan/85)



At first glance, this kind of movement in the value of the dollar appears to be perverse. Nevertheless, it is explained by the current strength of the U.S. economy and the investment opportunities it creates relative to other industrialized economies. Chart 8 compares the trend in industrial production in the United States with the performance of Japan and the European members of the Organization for Economic Cooperation and Development (OECD), since the end of the recession. The chart shows, quite dramatically, the continued stagnation of the Western European nations, in spite of the fact that real GNP has recovered. These low rates of industrial production help explain why European unemployment rates remain high, and in some countries, such as France and the United Kingdom, actually rose during the past year. In turn, this is reflected in the low level of consumer optimism in the West European nations. The recent Gallup survey noted that 34 percent of the British, 25 percent of the German and only 15 percent of the French citizens queried thought that 1985 would be a better year than 1984. This compares to 61 percent for the American consumer.

CHART 8
Recovery Experience:
Industrial Production Index
(1982:11 = 1.0)



It must also be pointed out that, in spite of the problems that remain in the American economy, the U.S. recovery has been a major factor in the worldwide recovery now underway. Data released by the Federal Reserve Bank of St. Louis in October of last year show that each of the major trading partners of the U.S., with the exception of France and the United Kingdom, have shown a substantial turnaround in real GNP which was associated with a similar turnaround in their exports to the U.S. In fact, the data indicate that this stimulation of exports is more closely related to the U.S. recovery than to the appreciation of the dollar.

Although the outlook is one of continued growth in Western Europe and Japan, the anticipated future path of economic activity in the United States is significantly stronger. As a result, foreign investors see the U.S. economy as the one offering the most attractive investment opportunities and continue to demand dollars. This situation is likely to persist as long as the United States economy continues to outperform that of its major trading partners. While this is likely to be the case, the growth gap can be expected to be reduced as industrial production strengthens in Western Europe and Japan. Such an outcome, together with a continued decline in U.S. interest rates, can be expected to place downward pressure on the dollar. Any decline in the dollar's value, however, can only be expected to be gradual, particularly given our forecast of a continued positive business environment in this country.

The plight of U.S. export industries resulting from the loss of competitiveness in foreign markets due to the high value of the dollar has been well documented. However, it needs to be emphasized that U.S. exports have not suffered during this recovery. In fact real exports have risen by seven percent since the end of the recession. The surge in real imports, however, has been significantly stronger than average.

While a decline in the dollar's value can be expected to foster a rise in export growth, and in fact, it is just such an increase that we foresee for 1986, the improvement in the trade balance cannot be expected to be immediate. The initial effect is likely to be negative as price effects offset volume effects. The impact on inflation, on the other hand, is likely to feed through rather promptly.

Nevertheless, the source of the anticipated increase in demand for U.S. exports is not only the expected decline in the dollar's value, nor is it the strengthening of the European recovery alone. Western Europe is no longer the largest market for U.S. exports; the Asian countries edged Europe out of its prominent position in 1981. The recovery in the Asian economies, particularly the Pacific Basin nations, has been quite strong, and prospects are for a continuation of that trend. While the Latin American nations have been burdened by massive foreign debt service obligations, two developments, namely, the fall in U.S. interest rates, and the decline in the world price of oil, substantially improve the outlook for these nations which have accounted for as much as 40 percent of U.S. exports to developing countries.

Conclusion

Given our assumption of no further sharp declines in the growth rate of the money supply and no new tax increases, the U.S. economy can look forward to two more years of stable, strong, noninflationary growth. However, as we saw during the third quarter of last year, volatility in the growth of the money supply can have a depressing effect on overall economic activity. The monetary authorities should strive to maintain a stable growth rate in the money supply to minimize uncertainty in the financial markets.

UNITED STATES ECONOMIC OUTLOOK 1983-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS								YEARS			
	Actual		Forecast						Actual		Forecast	
	84:3	84:4	85:1	85:2	85:3	85:4	86:1	86:2	1983	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	1.6	3.9	5.1	5.3	5.1	5.4	4.8	5.1	3.7	6.8	4.6	5.1
Consumption	0.7	3.9	4.1	4.6	4.2	4.1	3.7	4.0	4.8	5.3	4.0	4.0
Residential Investment	-4.5	-2.0	0.6	14.1	23.6	20.8	17.3	9.2	41.7	12.4	5.9	13.9
Business Fixed Investment	13.7	11.1	12.5	12.0	12.1	12.9	14.3	14.1	2.5	20.0	12.8	13.4
Equipment	18.6	8.4	14.6	12.9	12.2	12.6	14.9	14.3	7.3	21.7	13.5	13.6
Structures	2.0	18.4	7.3	9.6	12.0	13.6	12.8	13.7	-7.8	15.7	10.9	12.7
Exports	7.7	-3.2	3.0	9.4	7.1	9.0	9.9	9.4	-5.6	4.6	4.2	9.2
Imports	55.4	-26.6	9.7	8.7	8.6	8.2	8.1	8.1	7.6	27.1	5.6	8.1
Government Purchases	5.4	6.6	2.3	4.1	3.1	0.2	0.5	0.4	-0.3	3.5	4.7	0.9
Inventory Change ($ B)	72	31	40	37	35	40	38	39	-13.5	57	38	39
New Car Sales (mil. units)	10.3	10.2	10.8	11.0	11.1	11.3	11.3	11.4	9.2	10.4	11.1	11.5
Housing Starts (mil. units)	1.7	1.6	1.7	1.8	1.9	1.9	2.0	2.0	1.7	1.8	1.8	2.0
EMPLOYMENT, WAGES AND PRICES												
Unemployment Rate (%)	7.5	7.2	7.0	6.9	6.7	6.5	6.4	6.3	9.6	7.5	6.8	6.2
Compensation	3.6	3.3	5.5	5.0	5.0	5.7	7.0	6.3	4.8	4.1	4.6	6.2
Productivity	-0.7	1.1	3.0	3.6	4.1	3.4	2.8	2.7	3.4	2.7	2.6	3.1
Unit Labor Costs	4.6	1.9	2.4	1.3	0.9	2.2	4.1	3.5	1.3	1.4	1.9	3.0
Consumer Prices	3.6	3.9	3.2	2.6	2.9	3.2	3.6	3.7	3.2	4.2	3.3	3.4
GNP Deflator	4.0	2.4	4.2	3.0	2.7	3.5	3.7	3.8	3.8	3.7	3.3	3.5
Prime Interest Rate (%)	13.0	11.8	9.9	9.7	9.5	9.5	9.3	9.0	10.8	12.0	9.7	8.7
Profits from Current Production ($ B)*	199.8	203.7	213.3	227.4	235.6	240.9	238.8	242.6	149.4	195.9	229.3	243.0
GOVERNMENT FISCAL POLICY ($BILLION)**												
Unified Budget—Receipts									601	666	745	810
Unified Budget—Outlays									796	842	945	990
Unified Budget—Federal									-195	-175	-200	-180

*Corporate profits after tax with inventory valuation and capital consumption adjustments.
**Unified Budget figures on a fiscal year basis.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revised estimates of the national income and product accounts for the third quarter of 1984, and the preliminary estimate for the fourth quarter of 1984. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates and the Tax Reform Act of 1984. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government outlays of $17 billion in calendar year 1986. As a result, the Federal Reserve is expected to be slightly more accommodative than would otherwise have been the case; M(1) is allowed to grow by 6.7% in 1985 and 1986, still within its target range. Continued weakness in crude oil spot prices is expected to contribute to a cut in the OPEC marker price from $29 per barrel at present to $25 per barrel by mid-1985. The federal minimum wage is assumed to remain at $3.35 an hour throughout the forecast interval. Sustained growth in foreign markets and falling U.S. interest rates are expected to foster a partial exchange rate correction. The trade-weighted average exchange rate falls by 0.6% in 1985 and 8% in 1986.

Similarly, fiscal policy should address runaway federal spending to free resources and reduce the proportion of GNP that goes to the public sector. Further, strong growth in business investment requires an environment of relative certainty with regard to tax policy. The consideration of tax reform proposals which shift the burden of taxation from consumers to producers (see the article that follows for a discussion of these proposals), engenders uncertainty and thwarts business plans.

THE U.S. TAX SYSTEM: THE TIME IS NOW FOR POSITIVE REFORMS

by

David R. Burton and Graciela Testa-Ortiz*

The tax reform debate has moved to the top of the political agenda. The Treasury Department has released its long-awaited tax reform proposal, a plethora of tax bills have been introduced for consideration by the Congress, and virtually every trade association and political group is organizing to influence the upcoming tax fight.

Throughout the debate, however, we should not forget that the goal of tax reform should be to enhance economic growth. Reduced marginal tax rates and capital cost recovery allowances that reduce or eliminate the tax bias against savings and investment will increase economic growth. Increased economic growth, in turn, will increase employment, raise tax revenues, reduce federal expenditures and help solve the deficit problem. Not just any tax reform proposal, however, will increase growth. As it stands, our tax structure fails to meet this goal. The complexity of the U.S. tax structure, the costs of compliance and administration, and the tax burden on the average taxpayer have grown markedly over the past four decades. The tax system includes hundreds of statutory provisions and myriad rulings, revenue procedures, and regulations. Estimates of the costs of compliance to individuals and businesses and administration by the government reach $60 billion per year. But most importantly, the marginal tax rate for the median income taxpayer has reached 25 percent compared to less than nine percent in 1947. This increase in the tax burden occurred in spite of the tax reduction embodied in the Economic Recovery Tax Act of 1981 (ERTA). ERTA's tax reduction has been erased by inflation-caused bracket creep and post-ERTA tax increases.

The steady increase in the tax burden has discouraged work effort and encouraged the underreporting of income. The system is biased against savings since it rewards consumption and encourages debt while penalizing savings through the taxation of capital gains, dividends, and interest on savings. This bias is, in part, responsible for the low U.S. savings rate relative to other industrialized nations. Finally, the proliferation of special exemptions and deductions has significantly narrowed the tax base.

ERTA WAS A FIRST STEP IN THE RIGHT DIRECTION

The virtues of lower tax rates and liberalized, more neutral, capital recovery allowances were nicely demonstrated by the economy's response to ERTA. That act created the Accelerated Cost Recovery System (ACRS), which, combined with the investment tax credit, constituted an important step towards a tax system that encourages savings and investment. ERTA also reduced individual tax rates by 25 percent across the board, making it more attractive to work, save, and invest. The combination of incentives provided under the 1981 tax act were the major contributor to the strength of the current expansion. In fact, investment thus far has increased twice as fast as during similar periods in past recoveries. Moreover, the wealthy increased their economic activity so much in response to the reduction in the top marginal tax rate, that they are both paying more taxes and paying a larger share of the total tax burden.

Another ERTA innovation, effective this January, is tax indexing. Tax indexing will prevent inflation from gradually pushing all taxpayers into higher tax brackets, thus ending the hidden, inflation-caused, tax increases which represented a significant drag on economic growth and progress.

Unfortunately, tax legislation since 1981 has been a major step backwards from the reforms achieved under ERTA. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the latest Tax Reform Act of 1984 reduced the value of ACRS and increased other taxes by almost $50 billion annually. In fact, according to the U.S. Treasury Department, these two bills, bracket creep, Social Security payroll tax increases, and gasoline tax increases combined to eliminate the entire ERTA tax cut, save $1.2 billion annually.

RECENT TAX REFORM PROPOSALS

The many tax reform bills now under consideration lower tax rates and broaden the tax base by eliminating deductions, credits, and exclusions from the tax code. Looking past that broad similarity, however, they differ substantially. Some retain a very progressive rate structure while others have a single flat rate. Some accentuate the tax bias against savings and investment while others reduce it. Some create new administrative problems and cost. Other, less important, differences also exist.

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*David R. Burton is a tax specialist with the U.S. Chamber of Commerce.

Most proposals, though not all, are considered to be revenue neutral in static terms. This means that the proposals can be expected to raise the same tax revenues as the present system if the following assumptions hold. First, that the changes in the tax code have no effect on overall economic growth, and second, that taxpayers' behavior does not change in response to tax code changes. These accounting-like revenue estimates are taken very seriously in Washington, even though they rest on the absurd premise that the tax law does not affect economic decision-making, and hence, economic activity. More realistic dynamic revenue estimates, which try to account for changes in individuals' actual behavior, are derided as inexact. Exact inaccuracy, of course, is of little value.

The Fair and FAST Plans

The two most prominent tax reform bills being considered are the "Fair Tax" introduced by Senator Bradley and Representative Geph. rdt, and the "Fair and Simple Tax (FAST)" plan introduced by Representative Kemp and Senator Kasten. In many respects, the bills are similar. Of the two, however, the Kemp-Kasten proposal would have much more positive economic effects and taxes families in a more advantageous manner.

Although both bills dramatically reduce individual tax rates and increase the personal exemption, the Kemp-Kasten bill has both lower rates and a larger personal exemption. Further, FAST doubles the dependent allowance and maintains tax indexing while the Bradley-Gephardt bill keeps the dependent allowance at $1,000 and repeals indexing.

On the corporate side, both bills reduce the corporate tax rate but also eliminate the investment tax credit, and repeal the 1981 reduction in the capital gains tax rate as well as scores of other deductions, exclusions, and credits. FAST, however, phases in repeal and indexes the capital basis. The Kemp-Kasten bill retains ACRS, while Bradley-Gephardt replaces it with a substantially less adequate depreciation system. In short, in each important area of difference, Kemp-Kasten is superior to Bradley-Gephardt, and more adequately fulfills the requisites for an optimal tax system.

In spite of the fact that both bills reduce the corporate tax rate, other provisions would have the net effect of raising the cost of capital, as a result, fixed investment would suffer. Because the investment tax credit favors investment in producers' durable equipment, its elimination could result in a shift in the investment mix away from equipment and in favor of investment in nonresidential structures. Although FAST's treatment of investment is more constructive than Bradley-Gephardt's, the scaled back capital cost recovery allowances and higher capital gains tax in both bills can be expected to hinder capital formation and reduce productivity.

The repeal of indexing under Bradley-Gephardt means that lower tax rates, for many Americans, would be only temporary, gradually disappearing as inflation pushed them into higher tax brackets. As a result, incentives to save and invest can be expected to suffer under this proposal. The reduced rate at which mortgage interest is deductible in both bills will hurt the housing market. Since the tax subsidy of housing is capitalized into existing home prices, home values can be expected to decline and limit both the demand for and supply of new homes. Demand will fall due to the wealth effect from the loss of homeowner equity and the increased net-of-tax cost. More than half of the new and existing home demand comes from existing home owners "trading up" to larger houses. All current owners will take a capital loss, limiting their ability to stretch for a larger and more expensive home. Lower prices for existing, and consequently, new homes, will squeeze builders' profit margins, reducing supply.

The nondeductibility of interest paid on debt can be expected to result in reduced credit demands and lower interest rates. This, in turn, should reduce the interest payment on the federal debt and, thus, the federal deficit, further reducing credit demands. Lower interest rates and the reduction in the corporate tax rate may offset a significant portion of the deleterious effect of other tax increases on businesses. While the foregoing analysis of the likely impact of lower interest rates resulting from these proposals follows conventional notions, there is evidence to suggest that the expected stimulus to investment from lower rates of interest may not be forthcoming.

The determinants of the rate of return of an additional dollar of investment include, not only the real rate of interest, but also technology, and taxes. In a recent paper, Robbins, Robbins and Roberts have shown that the most important component of the service price for nonresidential corporate investment is technology, which affects the relative productivity of alternative investments (See Robbins, A.E., Robbins, G.A., and Roberts, P.C., *Supply Side Economics and the Cost of Capital).* The second most important determinant, according to their calculations, is taxation, including property, sales and income taxes. The current tax structure increases the service price of capital by 30 percent for investments in both equipment and structures. On the other hand, the elasticity of the service price of capital with respect to the after-tax interest rate is only 0.11, implying that a ten percent decrease in the real after-tax interest rate will increase the service price of capital by only 1.1 percent.

This explanation sheds some light on the recent performance of the investment sector. In general, the forecasting community failed to foresee the strength of nonresidential investment during this recovery because real interest rates were deemed too high to support high levels of investment. As a result, the record-breaking strength of the nonresidential sector surprised almost everyone. However, recall that ERTA sharply reduced the cost of capital. The positive impact of lower tax burdens, together wih the rapid advances in technology now underway, served to offset the negative impact of high real interest rates yielding the capital boom that we are currently experiencing.

The Treasury Proposal

The Treasury Department's tax reform proposal is disappointing because it reverses many of the wise policies enacted in 1981. It also shifts the tax burden away from consumers towards producers. While individual, estate and gift, and excise tax receipts would be reduced over the 1986-1990 period, corporate taxes, under this proposal, more than offset this decline, rising an astonishing $165 billion. The proposal would eliminate the capital gains exclusion, the investment tax credit and ACRS. The capital cost recovery system that would result from this plan is the worst since the Great Depression. Buildings would be depreciated over 63 years and equipment over 12 to 25 years. Furthermore its corporate tax rate reduction, from 46 percent to 33 percent, compares poorly to other reform proposals. Business taxes would increase by 25 percent in 1986 and 36 percent by 1990. Small businesses would be particularly hurt by burdensome new administrative requirements in the fringe benefit and depreciation areas. Capital basis indexing and partial dividend relief are two of the few positive aspects of the plan.

On the individual side, the maximum tax rate would be reduced to 35 percent and many deductions, credits, and exclusions would be repealed. This, however, is the highest tax rate of any major reform proposal. The tax treatment of savings and investment under the plan is less neutral than present law and most reform proposals (including Bradley-Gephardt), now under consideration. However, some positive provisions are incorporated into the Treasury plan, including increased annual IRA deduction amounts, and doubled personal and dependent exemptions.

Compared to current law, the Treasury tax plan can be expected to result in a falloff in fixed investment but slightly stronger consumer spending. Both personal consumer spending and savings would rise as a result of the reduction in individual income tax rates which contribute to increased after-tax income. Personal savings would also benefit from the increase in the IRA limit. Higher after-tax wages would raise the supply of labor placing downward pressure on wages and reducing labor costs. At the same time, however, the repeal of the investment tax credit and ACRS would raise the cost of capital. Consequently, the capital-labor ratio will decline. The combination of reduced capital formation and a lower ratio of capital to labor can be expected to reduce output per manhour and, thus, diminish the economy's future growth prospects.

Even with tax rates reduced from 46 to 33 percent, with dividend payouts inceased to 50 percent, with high rates of inflation and relatively low real discount rates, the Treasury proposal would dramatically raise the user cost of capital. Using Treasury's assumptions of five percent inflation and four percent real interest rates, investors in ACRS three-year property would experience a three to four percent increase in their capital costs. Similarly, investors in ACRS five-year property, representative of most equipment, would see their costs increase by nine to 12 percent. The capital costs for structures would decrease 11 percent. Higher real interest rates (such as those we are currently experiencing) would cause all of these capital costs to increase and result in higher capital costs for structures than at present.

Only adequate capital cost recovery allowances allow the economy to grow as quickly as would be possible under an unfettered free market. Exacerbating the tax bias against investment, as the present Treasury proposal does, constitutes a reversal of the pro-growth policies inaugurated in 1981. It is clear that the anti-growth aspects of the plan's dramatic increase in capital costs will swamp its moderate pro-growth aspects, such as reduced tax rates on labor income.

As with the FAST and Fair proposals, the reduced deductibility of interest payments can be expected to diminish credit demands and interest rates. Reduced wage pressures can be anticipated to result in lower prices. Over the longer run, the combination of lower interest rates and lower inflation may help improve the investment environment; however, the nation's capital stock will be left at a lower level than would otherwise have been the case. As with the Fair and FAST plans, however, it is not clear that the resulting decline in nominal interest rates will spur investment sufficiently to offset the negative impact of higher tax burdens on capital. The impact on the housing market should be similar to that of the Fair and FAST plans.

Other Tax Reform Proposals

Senator Roth and Representative Moore have introduced the Broad-Based Enhanced Savings Tax Act (BEST). This bill, in contrast to the Fair Tax and FAST would be unambiguously good for the economy because it both lowers rates and has a more neutral tax base. The bill eliminates the discrimination against capital expenses. It allows plant and equipment to be deducted in the year incurred just like any other expense. Real property, however, is not expensed. The bill creates a super-savings account, similar to an Individual Retirement Account (IRA). Taxpayers could deduct up to $20,000 in savings and would pay tax, but no penalties, for withdrawals. The bill lowers the top individual rate to 34 percent by 1990. This bill, which can best be described as a step towards a consumed income tax, deserves very serious consideration as an alternative to tax reform bills which lower tax rates by increasing the tax bias against savings and investment. The bill does not, however, address the corporate tax.

Representative Heftel's "Cash Flow Income Tax" is a fairly pure consumed income tax. It eliminates the discrimination against capital assets by expensing all investment. All savings are deductible but taxable upon withdrawal. Furthermore, the double taxation of corporate income is dramatically reduced, although not eliminated, by the bill's deduction for both cash and stock dividends. Except for an individual's first $20,000, all loans are included in the tax base while principal and interest payments are deductible. The current preferred status of primary residences is retained. The top rate, on income above the Social Security wage base, is 30 percent. Representative Heftel's proposal has the merit of almost entirely eliminating the tax bias against savings. Furthermore, it maintains tax rates as low as most other bills—including those with substantially less attractive tax bases. The bill would have an unambiguous, strong, positive effect on capital formation and, consequently, employment and growth.

Senator DeConcini and Representative Shelby have introduced the 19 percent flat tax plan originally proposed by Robert Hall and Alvin Rabushka in their book *Low Tax, Simple Tax, Flat Tax*. This system appears simple and straight forward, but its apparent simplicity is partly caused by the many questions it leaves unanswered. The proposal expenses capital expenditures. It does not allow businesses to deduct interest payments or costs associated with fringe benefits. Thus, in effect, it has a 19 percent withholding tax on investment, savings, and fringe benefit income. The bill does not tax individuals' savings income. However, many middle income taxpayers would experience tax increases under this plan because literally every personal deduction is eliminated and the 19 percent bracket starts (in the version to be introduced in the next Congress) at $9,000 for joint returns. The dependent allowance is $1,800. The proposal is interesting but needs a great deal of elaboration before it could be enacted.

Representative Siljander and Senator Nickles have introduced a ten percent flat tax. The bill does not address the corporate tax. There is little doubt that this bill would reduce federal tax revenues. Such a dramatic reduction in tax rates, combined with the retention of ACRS, would no doubt spark an unequaled supply-side effect. To the extent that this burst of growth did not expand the tax base enough to keep the federal deficit within reasonable limits, however, the bill may have adverse economic impacts. Based on historical federal and state experience, the tax amnesty proposal in the Siljander-Nickles bill can be expected to raise about $6 billion to $8 billion—a large sum, but not enough to make up all lost revenue. Unless federal spending is reduced enough that revenue shortfalls did not pose a substantial problem, the Siljander-Nickles proposal is a high risk proposition.

CONCLUSION

Tax reform could dramatically increase economic efficiency and spark unequaled economic growth. But all tax reform proposals are not created equal and some are clearly better than others. The wrong kind of tax reform, in particular a tax system which shifts the burden to the corporate sector, as many of them do, could have very serious long run effects on the U.S. economy.

In addition to being simple, efficient, and fair, a constructive tax system must reduce marginal tax rates, *and* reduce the tax bias against savings and investment if it is to have a positive effect on employment and economic growth.

Further, the optimal tax reform package would conform to the following principles. First, tax reform must not become an euphemism for tax increases. Second, any attempts to reduce the federal deficit should concentrate on spending reduction and economic growth, not tax increases. In the previous issues of ECONOMIC OUTLOOK (see the December, 1984 issue) we have shown the extent to which federal spending is out of control and the opportunities available to reduce spending growth. In our analysis of the high growth agenda we have also shown that policies geared toward sustaining a healthy business environment would promote economic growth and reduce the deficit.

Other important principles of tax reform include the following: tax reform should reduce or eliminate the progressiveness of our tax rates; it should retain indexing so that the government may not surreptitiously profit from inflation; and finally, tax reform should not mislead the public regarding the amount of tax they are actually paying.

GIVING FREE TRADE A BAD NAME

by
Rajni Bonnie Ohri

> *"Before I built a wall I'd ask to know*
> *What I was walling in or walling out,*
> *And to whom I was like to give offence."*
>
> *—Robert Frost*

Despite the strength of the U.S. business upswing, trade officials are alarmed by the rumblings of a protectionist avalanche that could bury the global economic recovery under the rubble of the trading system. With the U.S. trade deficit mounting towards $120 billion in 1984—double the level of 1983—alarm is understandable. Protectionist pressures are being stoked in the U.S. by the strong dollar, in Europe by stubbornly high unemployment, in developing countries by the need to earn foreign exchange to pay off huge debts, and almost everywhere by industrial and social adjustments being forced by technological change.

International trade is very important to American farmers and manufacturers, and of increasing significance to our service industries. Over twenty percent of our industrial output and 40 percent of our agricultural products are exported. One-third of all corporate profits come from foreign trade and investment. From 1960 to 1983, the ratio of imports to GNP rose from 4.6 percent to 10.4 percent while the share of exports in GNP increased from 5.7 percent to 10.2 percent. One implication of this growing international orientation is the increase in the proportion of the labor force that is affected by international trade. The proportion of manufacturing employment related to exports rose from 8.1 percent in 1970 to 14.5 percent in 1980 while at the same time, the proportion of manufacturing jobs facing import competition rose from 8.4 percent in 1970 to 14.7 percent in 1980. Other productive factors also have an increasing stake in foreign trade. During the same period, the import-related share of manufacturing value added increased from 8.3 percent to 14.4 percent, and the export-related share increased from 8.5 percent to 15.1 percent.

Defending Free Trade

Advocacy of an open trade system—free exchange of goods among countries—has been a part of the foundation of America's international leadership. The arguments in favor of free trade are supported by historical evidence. During the 1930s, the U.S. and many other countries followed "beggar-thy-neighbor" trade policies which contributed to the worldwide depression. The Smoot-Hawley protectionist tariff epitomized this approach in the U.S. Subsequently, U.S. trade policy shifted to the negotiation of reciprocal trade agreements. These tariff reductions were followed by an acceleration in world trade and economic growth. International trade was an engine of growth during the 1960s and 1970s, largely because of the decline in tariffs negotiated through the General Agreement on Tariffs and Trade. World tariffs now average only around 5 to 10 percent of the value of imports, compared to 53 percent in the 1930s.

Free trade is viewed by many experts as best for the economy as a whole. Whether from domestic or foreign sources, competition forces firms to follow lowest cost, highest productivity practices to satisfy consumers at the lowest prices. An open trading system contributes to lowering inflationary pressures by increasing the supply of goods and services competing for the consumer dollar. It also minimizes the role of government in influencing private sector decisions, thus allowing individuals and business firms to respond to the needs of the marketplace. In addition, free trade allows the price mechanism to allocate resources by drawing labor, capital and other factors into their most productive uses. It thereby yields more growth, higher levels of employment, and an improved standard living at home. Society as a whole gains because free trade increases both the quality and quantity of the goods available for consumption.

The Costs of Protectionism

The costs of protectionism are high. They include costs to domestic consumers in terms of higher prices and limited choices; they inflict damage on the heavily indebted foreign nations struggling to increase export earnings; and they incur costs to domestic exporters who might face retaliation. Also at risk are the very groups whom trade restrictions are supposed to protect. Although relief from tough foreign competition may temporarily benefit protected industries and workers, nobody benefits from losses in production and consumption which occur when the protected companies produce inefficiently and the resulting high prices discourage some buyers. In addition, many of these industries also risk widening the cyclical swings in the demand for their products.

Ultimately, the costs of protectionism are borne by consumers in the form of higher prices. Consumers face a narrower range of goods and higher prices as imports are restricted. Thus, protectionism can be viewed as a hidden tax on the consumer. A recent study by the Center for the Study of American Business estimated that in 1980 this hidden tax came to more than $58 billion, or $255 per American consumer. Another report by the Center showed that voluntary quotas on imports of footwear, which were eliminated by the Reagan administration, acted as a regressive tax that hurt low-income consumers relatively more than those at higher levels.

Robert Crandall of the Brookings Institute estimates that automobile quotas have raised the price of Japanese cars sold in the U.S. by about $900 and bid up the price of domestic cars by nearly $400, implying a consumer cost of nearly $4.5 billion yearly. Martin Wolf of the Trade Policy Research Center in London has placed the cost of textile and apparel tariffs and quotas at about $12 billion annually for U.S. consumers. And statistical estimates by the International Trade Commission show that U.S. consumers paid an extra $700 million annually because of footwear protection in 1977-81. Most studies show that consumer costs far outweigh the adjustment costs in the form of temporary unemployment that might be experienced absent protection.

Other countries have not fared any better. European agricultural policy costs European consumers nearly $20 billion per year. For every $20,000 per year job protected in Swedish shipyards, Swedish taxpayers pay an estimated $50,000 annual subsidy. When Japanese consumers pay eight times the world price for beef, Japanese farmers are not made eight times better off. It costs them that much more to produce it. And, though Swiss wine drinkers pay $50 million more than they would at world prices, Swiss producers have nothing left over for high living.

Protectionist measures are a two-edged sword. They may well reduce imports from abroad, but at the same time they make it more difficult for domestic firms to export their products. From the viewpoint of economic performance, protectionist measures are counterproductive, impoverishing domestic and foreign producers and consumers alike. In addition, they reduce competition. By encouraging capital and labour to stay in less-efficient industries, they also result in lower productivity and output, especially by the domestic industries purchasing the products of the protected companies. All this generates pressures for additional protectionist measures.

Around the world, trade barriers are erected to keep out American products, while imports come into the U.S. in a flood that threatens to swamp our industries (see Table 1). For example, U.S. exporters to Japan encounter not only relatively forthright trade barriers, but also complex wholesale and retail distribution systems and even, a national ethos that discourages the purchase of foreign goods. Japan has restricted imports of textiles, apparel, autos, telecommunications equipment, footwear, finished wood and paper products, leather, and pharmaceuticals from the U.S. But, protectionist measures are not aimed solely at the U.S. The EEC (European Economic Community) has slapped restraints on imports of steel, tape recorders, television sets, machine tools, autos, and ten other important manufactured products from Japan as well as the U.S. Canada has put up barriers to imports of textiles, apparel, steel, autos and both leather and nonleather footwear.

TABLE 1

U.S. IMPORTS AND EXPORTS 1984 VS. 1983
(percent change)

Area	Imports[a]	Exports[b]
Canada	28.8	23.2
20 Latin American Republics	19.1	15.9
Western Europe	32.2	3.2
United Kingdom	15.4	14.5
Federal Republic of Germany	35.0	4.1
Japan	41.8	8.2
Other Asia	27.1	-5.6
TOTAL	27.5%	8.6%

(a) U.S. imports, customs value basis (unadjusted)
(b) U.S. exports, F.A.S. value basis (unadjusted)
Source: U.S. Department of Commerce

New protectionist actions and reactions are loomimg in steel, autos, farm products, and other major trade categories. Since 1980 the U.S. has restricted imports of specialty steels, textiles, apparel, and motorcycles. It has negotiated agreements with the EEC to curb carbon steel exports to the U.S. and with Japan to limit auto sales in the U.S. Developing countries are rapidly becoming the next target for protectionist attack. Since World War II, their need to stimulate and protect their economic development by means of subsidies and import barriers has been tacitly conceded by the industrial nations. Although this indulgence has been reinforced recently by the developing countries' need to earn foreign exchange to pay their debts, there are signs that such forebearance is wearing thin.

Protectionist Threats on the Rise

U.S. trade critics tend to disregard the free trade arguments and instead, point to the fact that the U.S. is running a deficit in its merchandise trade account (see Table 2). And, in particular they tend to focus their concern on Japan, America's second largest trading partner, after Canada. During the period 1976-83, the U.S. incurred a cumulative trade deficit—primarily as a result of Japanese penetration into U.S. markets for textiles, television sets, automobiles, motorcycles, radios, photographic equipment, video tape recorders, watches, machine tools, and steel—of about $95 billion.

TABLE 2

COMPARISON OF U.S. MERCHANDISE TRADE WITH JAPAN AND WESTERN EUROPE
(billions of dollars)

Area	1976	1977	1978	1979	1980	1981	1982	1983
Japan								
Exports	10.2	10.6	13.0	17.6	20.8	21.8	20.7	21.9
Imports	15.5	18.6	24.5	26.3	31.2	37.6	37.7	41.4
Deficit	-5.3	-8.0	-11.6	-8.6	-10.4	-15.8	-17.0	-19.5
Western Europe								
Exports	31.9	34.1	39.6	54.2	67.6	65.1	59.7	55.9
Imports	23.0	28.2	36.6	41.8	47.3	52.9	52.9	53.8
Surplus	8.9	5.9	2.9	12.4	20.3	12.2	6.8	2.1
Net Surplus (+) or Deficit (-)	+3.5	-2.1	-8.7	+3.7	+9.9	-3.6	-10.2	-17.4

Source: U.S. Department of Commerce

Protectionists argue that U.S.-Japanese trade policies are asymmetric and claim that the Japanese market is closed to U.S. products. The following examples are used to prove their point: product design standards and their administration are intended to restrict the entry of U.S. products into Japanese markets; Japanese importers must cut through unnecessary red tape to obtain permission to import U.S. products; tariffs, particularly on finished wood and paper products, tobacco, refined copper, computer parts, chocolate, and leather, inhibit U.S. exports to Japan; targeted industries, particularly beef, citrus and electronics, are shielded from outside competition by Japan; other targeted industries are awarded special favors by Japan, and this gives them an unfair advantage to penetrate the U.S. market. In addition, direct foreign investment in Japan is difficult because Japan's policies are unclear and foreign investors are not accorded the same treatment as Japanese nationals.

A clear example of the asymmetrical trade relationship between Japan and the U.S. lies in the semiconductor industry. Japan Inc. has successfully leapfrogged over the last generation of semiconductor technology and now controls 56 percent of the U.S. market in advanced computer memories. The Japanese have accomplished this feat by keeping out direct U.S. investment, while insisting that U.S. manufacturers wishing to sell in the Japanese market share their technology with Japan. Texas Instruments was permitted to set up a joint venture with Sony, but had to limit its market share to ten percent and license its patents to Sony, Hitachi, Toshiba and Mitsubishi.

Given these complaints and the rising protectionist sentiment in the U.S., the administration's reaction has been relatively mild. Voluntary quotas for automobiles were agreed to, and restrictions were placed on various types of steel, motorcycles, and several other products. But to its credit, the Reagan administration has resisted other proposals for protectionist policies that would restrict Japan's ability to trade with the U.S. However, on January 10, the Federal Communications Commission announced that it is considering retaliating against Japanese trade barriers by requiring the same kind of product certification process that Japan uses to keep out U.S. products. The problem remains that the Japanese prefer export restraints to any significant steps to open up their own markets.

Japan is far from alone, however. Over the past few years, South Korea and other advanced developing countries such as Brazil, Mexico, and Taiwan have become formidable new rivals of the industrialized countries, not only in steel, but also in shipbuilding, machine tools, construction, and electronics. In its two way trade with the newly industrialized countries (Taiwan, Singapore, Hong Kong, South Korea, Malaysia, Thailand, Indonesia), the U.S. sells more than it buys in only *one* broad category of goods: food, feeds, and beverages. And, it's not surprising that, in agricultural goods, the U.S. has an edge, in view of the high ratio of population to arable land in the region. But in every other category, the newly industrialized nations come out ahead. These countries not only dominate the consumer goods sector but also run bilateral trade surpluses in industrial supplies, autos and capital goods. While the region's total exports to the U.S. climbed 136.7 percent in the first 8 months of 1984, U.S. exports to the region grew only 5.1 percent, largely due to the various import restrictions the region erects on U.S. products.

A case in point is Korea. Although Korea claims to have removed restrictions on some 83 percent of the products it imports, these restrictions were replaced in almost every case, with tariffs that have a similar effect. Korea's restrictive import licensing includes such U.S. goods as horticultural products, computers and related equipment, machine tools, consumer goods, and canned fruit products. Foreign cigarettes, in general, are completely banned from Korean markets.

The EEC is also looking towards protectionist measures against U.S. goods to ease a financial crisis brought on by the runaway costs of subsidies to European farmers. Brussels, for example, is expected to impose quotas on imports of livestock feeds, such as corn gluten, worth about $700 million a year to U.S. farmers. The EEC is also considering import duties on vegetable oils, which could drastically cut back $4 billion a year in imports of soybeans from the U.S. U.S. high technology exports and services have also suffered from European protectionism. AT&T has met with difficulty in selling its telecommunication equipment in Europe. Boeing's role as a leading producer of aircraft has also been eroded due to the penetration of the European Airbus into world routes previously dominated by Boeing.

Trade between the U.S. and Canada is the world's most extensive bilateral exchange, amounting to nearly $120 billion in 1984. But, protectionist sentiment is also running high against U.S. products. Canadian tariffs on selected items of U.S. agricultural equipment run as high as 14 percent. Tariffs on certain telecommunications products are significantly higher than U.S. tariffs on Canadian products (17.5 percent versus 8.5 percent). On the whole, by 1987 an estimated 85 percent of Canadian goods to the U.S. will have duty-free access while only 65 percent of U.S. goods to Canada will have the same privilege.

Conclusion

Overall, trade protectionism continued to rise last year as the effects of recession on employment persisted in the world economy and as exchange rates often responded more to developments in the financial sector than to trade flows. While world trade did expand modestly in 1983 in terms of volume—although it contracted in U.S. dollar terms—the ratio of trade volume growth to output growth remained below its long run level, reflecting the persistent dampening effects of rising protectionism in recent years.

The Reagan administration has made some inroads in trying to stem the rise of protectionism. Recently, the administration has been involved in trade talks with France and others aimed at reducing the subsidy element in export financing. These foreign subsidies are threatening U.S. industries such as commercial aircraft, machine tools, computer chips, and electric and nuclear power equipment that were once dominant overseas. In addition, expansion of trade and a reduction of trade barriers between the Soviet Union and the U.S. is being considered by the administration. The main goals of the President's trade policies include formulating rules for international trade in services, improving existing rules for government procurement and subsidies, and seeking common approaches to barter and trade with the Soviet Union, China and other nonmarket economies.

U.S. trade policies must serve to open markets abroad and to promote the competitive adjustment of U.S. industries in international trade, not to insulate the American economy. Clearly, the U.S. must stress access to foreign markets in those countries and in those sectors where the international competitive position of important sectors of the American economy is at stake. The choice now facing the major trading nations is between a further drift to protectionism or a joint effort to remove trade barriers. After all, free trade is a two-way street.

TRENDS IN COMMERCE
NOTES ON TABLE II

January/February 1985

by
Martin Lefkowitz

Gross National Product (GNP) - The Department of Commerce preliminary estimate for economic activity in the fourth quarter of 1984 indicates that GNP—the value of the nation's output of goods and services—grew at an inflation-adjusted annual rate of 3.9 percent, a significant upward revision from the earlier estimate of 2.8 percent. While the fourth quarter growth rate is a notable slowdown from the the first half of 1984 when GNP was growing at an 8.6 percent annual rate, it is more than double the rate of growth in the third quarter. The 6.8 percent rate of economic growth in 1984 was the best single year performance for the economy since 1951. The 1984 economy exceeded the expected rate of growth for the economy as predicted by 49 out of 51 business economists and forecasting services. Business fixed investment was up 20 percent for all of 1984, the best performance in recent economic history, and grew at an 11.1 percent annual rate in the fourth quarter, the sixth consecutive quarter of double digit investment growth.

Money Supply -The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.9 percent in December. This resulted in a 3.9 percent increase (seasonally adjusted annual rate) in the money supply in the latest three month period. This performance places the nation's money supply, up 5.5 percent from a year ago, in the target growth range of four percent to eight percent established by the Federal Reserve Board earlier this year. However, it remains below the six percent growth target set by the Federal Open Market Committee at its October 2 meeting.

Employment - Civilian employment—as measured by the monthly survey of households—jumped by 341,000 persons (seasonally adjusted), in December to 106.3 million, bringing the employment increase for 1984 to 3.2 million. The establishment data indicated that American businesses hired one million new workers in the last three months of 1984. The U.S. economy has created 7.3 million new jobs since the end of the recession in November 1982. Despite very rapid job growth, the civilian unemployment rate inched up in December by 0.1 percentage points to 7.2 percent.

Prices - The Consumer Price Index for all urban consumers (CPI-U) rose 0.2 percent in December, following a 0.2 percent increase in November. The December data reflects declines in gasoline and apparel prices. For the 12 months ended in December 1984, the CPI advanced 4.0 percent. This compares favorably with calendar year increases of 3.9 percent in 1982 and 3.8 percent in 1983. It also shows continued moderation of price increases despite rapid economic growth.

Wholesale prices of finished goods edged up 0.1 percent in December following a 0.5 percent increase in November. This was only the second increase in the last five months for this index which is composed solely of goods, and does not include services which are a part of the consumer price index. The wholesale price index for finished goods is now only 0.6 percent higher than it was six months ago, and only 1.8 percent higher than its year ago level. The December slowdown in the rate of increase for finished goods was due to a decline in energy prices and an across the board slowdown in most finished goods prices.

The more volatile part of the Producer Price Index, crude goods, declined 0.4 percent in December. Crude materials prices were 1.3 percent below their levels of a year ago this December.

Housing Starts - Privately-owned housing units were started at an annual rate of 1,587,000 in December, up 2.1 percent from November. The gain was the result of a jump in single family home construction that more than offset a loss in apartment building starts. This was the second consecutive monthly gain for housing starts. For 1984 as a whole there were 1,744,000 new housing units started, two percent more than in 1983 and the best performance for housing starts since 1979. Starts peaked early in the year at an annual rate of over two million units and then slowed significantly in the summer months, but made a comeback after interest rates started falling in the fourth quarter. Building permits in December were virtually unchanged from November averaging 1,588,000. This was a significant increase from September and October when permits fell to their lowest levels of the recovery.

Industrial Production - Industrial production increased 0.6 percent in December, the largest increase in five months. This followed a 0.4 percent increase in November which was preceded by declines in September and October. Increases in production occurred in all major groupings of the index. Fourth quarter industrial output was about the same as in the third quarter. However, industrial production in December was 6.4 percent higher than a year ago. Business equipment production rose 0.7 percent, following no gain in November. This placed business equipment production at 12.7 percent above the level of a year ago, double the increase in production for the entire index. U.S.mine production increased one percent in December, the largest increase for any market grouping. Consumer goods production rose by 0.6 percent in December, largely due to a 0.8 percent increase in durable goods as automobile production continued to rebound.

The capacity utilization rate for manufacturing, mining, and utilities moved up 0.3 percentage points in December to 81.9 percent. This was below the level of mid-1984 due to an increase in capacity. Capacity in the fourth quarter continued to increase as American industry added 0.6 percent to its output capability. This was 2.6 percent above a year ago. For 1984 as a whole the capacity utilization rate was 81.6 percent, the highest since 1979, yet still below the 1967-82 average of 82.4 percent.

Business Costs and Productivity - Private business sector productivity, as measured by output per man-hour of all people, increased at a 2.7 percent annual rate in 1983. Productivity continued its climb in the first half of the year as output per hour rose at a 4.5 percent average annual rate, but slowed to a 0.9 percent annual rate in the third quarter. In the nonfarm business sector productivity fell at a 0.7 percent annual rate. Manufacturing productivity increased at an eight percent annual rate, indicating a quick pay off on new equipment purchases. Third quarter unit labor costs were up 1.6 percent over their year-ago level, but below their first quarter rate. Unit labor costs were held down by the increase in productivity which offset increased costs for employee compensation.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Nov/84	237.6	237.5	235.5	0.1	0.9
Gross National Product ($B) [a]	IV/84	3,752.5	3,694.6	3,431.7	1.6	9.3
Gross National Product (72$B) [a]	IV/84	1,661.1	1,645.2	1,572.7	1.0	5.6
Money Supply (M1) [a]	Dec/84	554.3	549.4	525.4	0.9	5.5
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Dec/84	2,424.9	2,396.9	2,245.9	1.2	8.0
Personal Consumption Expenditures (72$B) [a]	Nov/84	1,074.7	1,065.1	1,031.3	0.9	4.2
Disposable Personal Income ($B) [a]	Dec/84	2,661.2	2,650.8	2,448.7	0.4	8.7
Disposable Personal Income (72$) [a]	Nov/84	1,188.6	1,182.7	1,123,3	0.5	5.8
Personal Savings Rate (%)	Nov/84	6.3	6.4	5.3	-0.1[b]	1.0[b]
Civilian Employment (millions) [a]	Dec/84	106.3	105.9	103.0	0.3	3.1
Civilian Unemployment Rate (%) [a]	Dec/84	7.2	7.1	8.2	0.1[b]	-1.0[b]
Average Hourly Earnings ($) [a]	Dec/84	$8.48	$8.42	$8.17	0.7	3.8
Consumer Price Index (All Urban, 67=100)	Dec/84	315.5	315.3	303.4	0.2	4.0
Purchasing Power of the Dollar	Dec/84	0.313	0.313	0.333	0.0	-6.3
Prime Interest Rate (%) January 25, 1985	Jan/85	10.5	11.25	11.0	-0.75[b]	0.5[b]
Retail Sales ($) [a]	Dec/84	110.8	110.9	102.4	-0.1	8.2
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	III/84	224.8	246.0	227.4	-8.6	-1.1
After Tax	III/84	141.7	150.2	142.6	-5.7	-0.6
Industrial Production (67=100) [a]	Dec/84	166.2	165.2	156.2	0.6	6.4
Capacity Utilization Rate (Mfg.) (%) [a]	Dec/84	82.2	81.9	79.0	0.3[b]	3.2[b]
New Housing Starts (thou. units) [a]	Dec/84	1,587.0	1,554.0	1,694.0	2.1	-6.3
Net Business Formation (67=100)	Nov/84	120.6	119.9	117.8	0.6	2.4
New Business Incorporations (Thousands) [a]	Jun/84	54.7	51.2	51.0	6.8	7.3
BUSINESS COST						
Unit Labor Costs (nonfarm) (77=100) [a]	III/84	159.4	157.6	155.9	1.1	2.2
Unit Nonlabor Costs (77=100) [a]	III/84	154.4	152.3	150.9	1.4	2.3
Producer Price Indices (67=100)						
Crude Materials [a]	Dec/84	329.0	330.4	333.6	-0.4	-1.3
Intermediate Goods [a]	Dec/84	321.1	321.6	317.1	-0.2	1.3
Finished Goods [a]	Dec/84	292.6	292.4	287.4	0.1	1.8
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100) [a]	Dec/84	605.5	579.7	532.0	4.4	13.8
Fed. Gov't Debt Outstanding ($B)	Sep/84	1,576.7	1,565.1	1,381.9	0.7	14.1
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	IV/84	364.7	368.6	346.1	-1.1	5.4
Imports of Goods & Services ($B) [a]	IV/84	429.0	459.3	375.9	-6.6	14.1
Balance on Goods & Services ($B) [a]	IV/84	-64.3	-90.7	-29.8	-29.1	115.8
WHAT'S AHEAD?						
Index of Leading Indicators (67=100)	Nov/84	166.6	164.5	162.5	1.3	2.5

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

Interest Rates - The prime rate, after remaining at 13 percent since June, fell to 12 percent in October. It continued to decline in December and now stands at 10.5 percent. Both short-term and long-term interest rates have declined sharply since mid-year. The federal funds rate, which was 11.47 percent in the week ending June 22, fell by 272 basis points, averaging 8.75 percent by January 4. At the same time Triple-A corporate bonds fell by 150 basis points, averaging 12.2 percent on the week of January 4th.

Business Failures and Formations - Dun and Bradstreet's Index of Business Failures for January indicates that failures were significantly below the levels of a year ago. The business discontinuance index, however, was higher than it was a year ago resulting in about the same rate of business closures for the month of December 1984 as in December 1983. The latest available data indicates that there were 269,984 new business incorporations in the first five months of 1984, a 9.9 percent increase over the same five month period in 1983. The largest percentage increases in the first five months of 1984 were reported in the following areas: Georgia, 32.1 percent; Washington, D.C., 31.9 percent; North Dakota, 30.7 percent; Maryland, 28.1 percent; and Virginia, 27 percent. Regionally, the largest percentage increase was reported in New England where new incorporations were up 17.2 percent.

Federal Spending - The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, indicates that federal spending increased 4.4 percent in December. Receipts for the month were up 7.2 percent from the same month a year ago due to large increases in personal income and social insurance taxes. Federal receipts for the first quarter of fiscal 1985 increased 11.2 percent from the same three months in fiscal 1984, but expenditures rose 12.2 percent resulting in a $9.1 billion increase in the federal deficit. The 12.2 percent increase in outlays is nearly three times the rate of inflation for the period. This indicates that efforts to control the federal deficit must be centered on expenditure control, since expenditures are increasing significantly faster than prices.

Personal Savings - According to Department of Commerce data, personal savings rose to 6.3 percent of after-tax income in the fourth quarter. Personal savings in 1984 were nearly $39 billion higher than they were in 1983, with the percentage of income saved increasing from five percent in 1983 to 6.1 percent in 1984. This means that one out of every six dollars in increased income in 1984 went into savings.

Retail Sales - Retail sales decreased 0.1 percent in December, following an increase of two percent in November. The December outcome stemmed from declines in gasoline prices and automobile sales for the month. The traditional areas of Christmas shopping—department stores, clothing stores and restaurants—all experienced double digit gains compared to last Christmas. December retail sales were 8.2 percent above year-ago level. This indicates that, after taking into account inflation, retailers sold about five percent more merchandise this Christmas than in 1983.

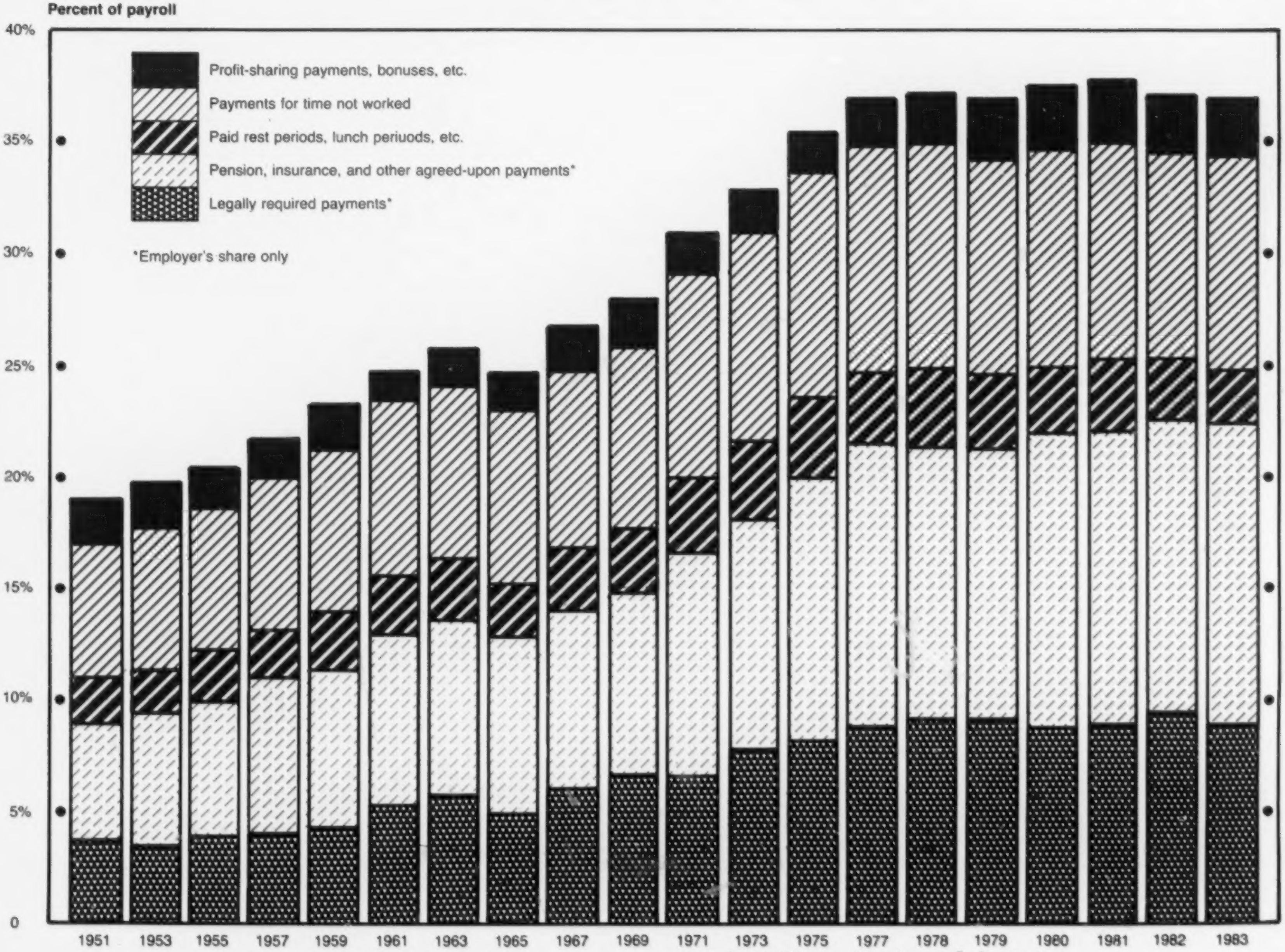
Trade Deficit - The trade deficit on a goods and services basis *decreased* from an annual rate of over $90.7 billion in the third quarter to $64.3 billion in the fourth quarter. The improvement is the result of a steep drop in imports which more than offset a slight decline in exports. The deficit for goods and services reached $66.3 billion in 1984, compared to only $8.3 billion in 1983, and surpluses of $19 billion and $28 billion in 1982 and 1981, respectively.

What's Ahead - The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 1.3 percent in November. The November increase was the largest single month gain since February. It was also a widespread gain as nine out of eleven available indicators rose. This follows a revised 0.5 percent decrease in October and a 0.9 percent increase in September.

U.S. CHAMBER SURVEY FINDS INCREASE IN EMPLOYEE BENEFITS

The latest U.S. Chamber survey of employee benefits found that employers were paying an average of $7,582.00 per hourly rated employee for the year 1983. This was 5.5 percent more than they paid in 1982, notwithstanding great efforts on the part of employers to hold down the burgeoning costs of employee benefits. As the chart shows, there has been a dramatic increase in benefits as a percent of payroll between 1951 and 1983. For information about ordering *Employee Benefits 1983*, call (301) 468-5128.

Total Employee Benefits as Percent of Payroll, 1951 to 1983



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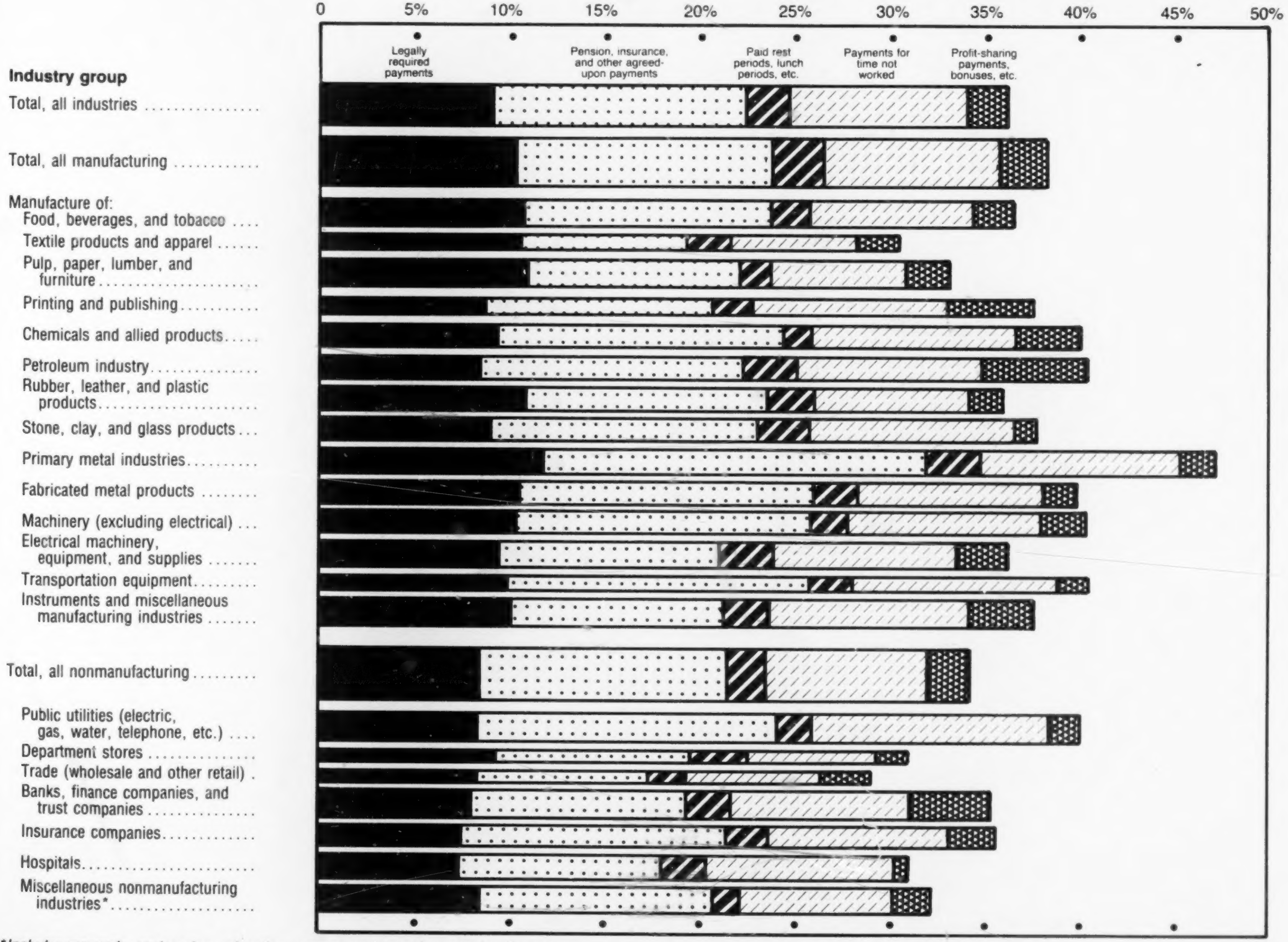
Employee Benefits as Percent of Payroll, by Industry Groups, 1,454 Companies, 1983



*Includes research, engineering, education, government agencies, construction, etc.

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ECONOMIC
OUTLOOK

Chamber of Commerce of the United States
March 1985

TAX REFORM AND THE FALLACY OF STATIC REVENUE ANALYSIS

by
Richard W. Rahn

This article is reprinted from the *Detroit News.*

The American people are overwhelmingly in favor of "tax reform" according to current polls. Why do we want tax reform? Because tax reform could produce a simpler and a more fair tax system, and most importantly, will generate increased economic growth.

Clearly, these are laudable goals, but ones that will be impossible to meet under the current congressional rules for tax reform. Each of the proponents of the various tax reform plans claim their plan is designed to be revenue neutral on a static basis. That is, it will produce the same amount of revenue as the existing tax code in future years, assuming no change in taxpayer behavior.

The problem is however, that by making both the business and personal sides of the tax code revenue neutral on a static basis, there would be as many losers as winners (i.e., for each taxpayer that has his taxes lowered, another taxpayer will have his taxes raised). Realizing the losers will scream louder than the winners, all of the major proposals have provided for an actual tax cut for individuals, and an actual tax increase for business. This is to insure there are more winners than losers.

Now the Catch 22. If you substantially increase business taxes, you will increase the cost of investment. Higher investment costs mean less investment, which means lower employment and productivity growth, and ultimately, lower real economic growth.

The way out of the dilemma is to design the tax reform package so it is revenue neutral on a dynamic rather than a static basis. Properly designed, the additional growth stemming from a more efficient tax system will allow more winners than losers on both the individual and business sides.

The fallacy of static revenue analysis can be understood when it is realized that federal tax increases are discussed as though they were simple additions to revenues, while spending cuts are viewed as simple subtractions from total outlays, much in the same way we approach our own household finances.

For instance, if you have determined that you are spending beyond your means by $1,000 a year, you have three choices. You could increase your income by that much, perhaps by working more overtime. Or, you could reduce your expenditures by $1,000, possibly by foregoing a planned vacation or do some of both. Similarly, the federal government, in attempting to trim the budget deficit by $100 billion a year, could increase its revenues by that much, reduce government spending by $100 billion, or do both. Unfortunately, at the federal government level, the analogy with our household finances ends.

The difference between a household and the federal government is that any action by the government will have an impact on the overall economy. This, in turn, will affect the federal budget – these are called "feedback effects." When feedback effects are ignored, the impact of a tax increase is estimated by multiplying the change in the effective tax rate the increase would imply, by the level of taxable income anticipated for that year. However, the fact is the change in the tax rate will result in changes in working and spending among households, and in hiring and investing by firms. These economic effects will, in turn, affect total gross national product and taxable incomes, thereby affecting tax revenues.

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Take the following example: assume your taxes are increased by ten percent. What will be your reaction? Your after-tax income will immediately fall by the amount of the tax increase. As a result, you will have to cut back on your expenditures; you may, for instance, decide to postpone buying a new car. Your decision, together with the decision of all other income-earners, will lower total demand for goods and services in the economy. Faced with a lower level demand, firms that supply those goods and services will reduce output. A reduction in output will usually mean that some workers will need to be laid off.

Already we see several economic effects at work as a result of increased taxes. Consumer spending has fallen, production has fallen, total taxable income has fallen and profits have fallen. What does this mean to the federal government? If income and profits are lower, then federal revenues will also be lower. This is true because taxes on individuals are levied on total income, and taxes on corporations are levied on total profits. At the same time, the ranks of the unemployed will swell. This means federal expenditures will be higher since payments for unemployment insurance, and a host of other social insurance programs will rise.

As a result, the impact of a tax rate increase on the federal budget designed to raise $20 billion in taxes on a static basis will neither increase revenues nor lower the deficit by that much. Rather, the impact on the deficit will be lower than the $20 billion for two reasons: (1) because the tax base has been reduced, revenues raised will be *less* than $20 billion; and (2) outlays for social insurance programs will have *risen*.

What this shows is that "static" revenue estimates can be very misleading indeed. We know for certain the tax rate increases on the deficit will, in every case, be different from the static estimate. The only way to approximate the actual impact of changes in fiscal policy is to perform a so-called "dynamic" analysis of the particular tax or spending change. A dynamic analysis takes the static estimate one step further – it asks what the impact of the proposed change on the overall economy would be, and how these induced changes in overall economic activity will then affect the federal budget.

In order to approximate the dynamic impact of a fiscal policy option, the static estimates are fed through an econometric model which simulates the workings of the real economy. Such a model is a system of mathematical equations, based largely on historical relationships which apply to the economy at large.

A properly constructed dynamic econometric analysis will not necessarily give precisely correct tax revenue and deficit figures resulting from tax reform. But, they are certain to be far less incorrect than the static figures.

If we *really* want tax reform, in part, to stimulate economic growth, then it is imperative that Congress and the Administration get away from the "static revenue neutral" charade. Instead, they should focus on how both individual and business taxpayers are apt to alter their behavior as a result of any proposed change.

FORECAST SUMMARY

by
Graciela Testa-Ortiz

Last month's economic news paints a picture of significant strength in the wake of the third quarter's poor performance. The Department of Commerce's revised estimates for fourth quarter real economic activity show that the economy grew by almost five percent, not the 3.9 percent originally estimated (see Trends in Commerce section for details).

Business inventories, which had risen by $72 billion in the third quarter, increased by only $35 billion in the fourth, reflecting a much needed inventory correction which has cleared the way for sustained growth in 1985. Total business inventories are expected to increase by $43 billion in 1985, following a $58 billion rise in 1984.

Consumer purchases staged a significant comeback during the fourth quarter, rising by almost four percent following a less than one percent increase in the third quarter. The outlook for consumer spending remains encouraging as the financial position of households, in terms of income and employment gains, remains strong. Real personal disposable income, which rose by 3.5 percent in 1983 and an impressive 6.7 percent in 1984, is expected to continue rising at rates close to four percent in 1985 and 1986. The changing characteristics of the American population are playing an important role in overall consumer spending. The strength in home sales that it implies will translate into increased purchases for housing-related consumer durables such as furniture and appliances. The large number of working couples contributes to an increase in the consumption of services. The only negative factor in the consumer picture is the level of consumer indebtedness in relation to income. The debt-to-income ratio rose to 17.6 percent in December, just

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two-tenths of a percentage point behind the 1979 peak of 17.8 percent. However, the data is now under revision and this may shave a percentage point off the ratio.

As we had anticipated, the housing market is showing renewed strength, with starts averaging 1.8 million units and existing home sales reaching three million units in January. In addition to the decline in interest rates, the strong income and employment performance, and positive consumer attitudes, the housing market is being supported by several other factors. Demographics, a major determinant of long-run housing activity, has supported, and will continue to support, a high level of housing starts even in the face of relatively high mortgage interest rates. In 1985, 42 million Americans will be in the 25 to 34 age bracket usually associated with the purchase of a first home. This figure is four million higher than the comparable 1980 number. Furthermore, almost 32 million people will be in the 35 to 44 age group this year, compared to 26 million in 1980. This age group is usually ready to move up to a larger home. As a result, demographic pressures alone are sufficient to support a level of housing starts of between 1.6 and 1.7 million units.

Several other factors play an important role in the demand for housing. Amongst these is an important increase in the supply of credit. Net nonfinancial credit doubled between 1982 and 1984. Further, the decline in outflows of U.S. funds has also increased the amount of loanable funds available to the housing market. The supply of loanable funds also received a significant boost from the deregulation of financial markets which removed the ceiling rates on deposit accounts, thus making it easier for thrift institutions to compete for funds. In the past, when interest rates rose above the statutory limits on deposit rates, savings and loans usually experienced a significant outflow of funds, thus limiting their ability to provide mortgage funds. Finally, the level of building permits authorized is consistent with a future level of starts of about 1.8 million units. Consequently, we expect total housing starts to remain close to the two million mark throughout the remainder of this year.

Sales of new domestic cars averaged 8.8 million units during February, the strongest one-month performance since early 1979. Several other factors, in addition to gains in income and employment, are expected to continue to support the strong performance of the automobile industry. Consumer attitudes regarding automobile purchases are very optimistic, in general, as consumers think now is a good time to buy a car. Also, the average age of cars and trucks now on the road, at 7.4 years, is high, supporting a surge in replacement demand for automobiles. Finally, the lapse of the voluntary quotas on imports of Japanese cars is expected to result in downward pressures on automobile prices as the supply rises. We anticipate total new car sales to remain close to eleven million units this year, compared to 10.4 million last year, and rise to 11.7 million in 1986.

For the first time since the recovery began, total business fixed investment growth averaged below double-digit rates during the fourth quarter. Nonresidential investment rose by 6.3 percent, mainly on the strength of a 19 percent rise in investment in structures. Weakness in new orders during the last months of 1984 were responsible for the poor performance of investment in producers' durable equipment. However, this indicator rose by 3.8 percent in January as new orders for defense capital goods and household durables increased by 12.9 percent and 3.7 percent, respectively. We expect the sector to recover from the fourth quarter lull due to the continuing need to modernize the existing stock of capital. Further, declines in the price of capital relative to labor should stimulate a continuation in the substitution of one factor of production for the other. Finally, uncertainty regarding the impact of tax reform proposals on the rental price of capital is also expected to stimulate nonresidential investment in the near term.

The trade sector will continue to be a net drain on national income in the near term. Although imports of capital goods declined in tandem with the fall-off in investment during the fourth quarter, imports are expected to continue to enjoy a price advantage in domestic markets. In spite of the dollar's strength, U.S. exports rose to a record $19.4 billion in January. However, a $29.7 billion rise in imports resulted in a $10.3 billion deficit on the merchandise trade account.

As has been the case in previous instances of government intervention in foreign exchange markets, the late February intervention cost the Treasuries of the countries involved $1.5 billion dollars and had no significant impact on the exchange value of the dollar. While it did decline in the days following the intervention, the dollar quickly recovered much of the value lost during that episode. Federal Reserve Chairman Volcker's recent announcement that because of the dollar's strength, the money supply may be allowed to grow slightly faster than would otherwise have been the case, has also caused a slide in the dollar's value early this month. While predicting the dollar's value has become a very difficult endeavor, the available information seem to support a further slight rise in its value during this year. The factors that argue for this strength are as follows: 1) The continued strength of the U.S. economy vis-a-vis the economies of western Europe, and the resulting attractiveness of investments in the United States (see the article that follows for a discussion of current trends in the European economies), and 2) The economic and political stability of the U.S. which renders it a safe haven in a troubled world.

One of the major threats facing the economy during the next two years is the risk that the growing protectionist sentiment in this country may find its way into ill-advised legislation. An import surcharge bill is already being considered on Capitol Hill which, if enacted, would

UNITED STATES ECONOMIC OUTLOOK 1983-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS								YEARS			
	Actual		Forecast						Actual		Forecast	
	84:3	84:4	85:1	85:2	85:3	85:4	86:1	86:2	1983	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	1.6	4.9	4.9	5.1	4.8	4.5	4.9	4.8	3.7	6.9	4.6	4.8
Consumption	0.7	3.6	5.2	3.9	4.0	3.8	4.2	4.5	4.8	5.3	4.0	4.1
Residential Investment	-4.5	-5.2	7.9	9.5	14.0	-2.4	0.8	4.2	41.7	12.2	3.7	4.6
Business Fixed Investment	13.7	6.3	12.6	12.4	11.8	10.8	10.8	10.3	2.5	19.6	11.8	10.8
Equipment	18.6	1.9	14.1	14.3	13.9	12.9	12.4	11.7	7.3	21.3	12.6	12.5
Structures	2.0	18.8	8.6	7.6	6.3	5.3	6.8	6.4	-7.8	15.7	9.6	6.4
Exports	7.7	2.2	8.8	9.4	7.8	6.9	12.6	9.6	-5.6	4.9	6.7	9.1
Imports	55.4	-31.9	12.8	12.3	12.1	9.6	6.1	6.9	7.6	26.5	6.1	8.6
Government Purchases	5.4	6.3	2.3	3.9	3.6	2.8	2.4	2.1	-0.3	3.5	4.8	2.6
Inventory Change ($B)	71.8	35.3	37.6	40.5	40.7	45.9	43.4	41.9	-13.5	57.9	41.2	44.1
New Car Sales (mil. units)	10.3	10.2	10.9	11.0	11.0	11.2	11.3	11.6	9.2	10.4	11.0	11.7
Housing Starts (mil. units)	1.7	1.6	1.8	1.9	1.8	1.8	1.8	1.9	1.7	1.8	1.8	1.9
EMPLOYMENT, WAGES AND PRICES												
Unemployment Rate (%)	7.5	7.2	7.0	6.9	6.8	6.7	6.5	6.4	9.6	7.5	6.8	6.3
Compensation	3.6	3.3	5.4	3.7	4.0	4.7	6.0	5.3	4.8	4.2	4.1	5.2
Productivity	-1.1	1.5	3.2	3.3	3.3	3.0	2.5	2.5	3.4	2.7	2.5	2.8
Unit Labor Costs	4.9	1.8	2.1	0.4	0.6	1.7	3.3	2.8	1.3	1.5	1.6	2.3
Consumer Prices	3.6	3.9	3.0	3.3	3.3	3.4	3.6	3.9	3.2	4.2	3.4	3.7
GNP Deflator	4.0	2.8	4.1	2.4	2.6	3.1	3.7	3.8	3.8	3.8	3.2	3.5
Prime Interest Rate (%)	13.0	11.8	10.5	10.4	10.3	10.0	10.0	9.8	10.8	12.0	10.3	9.8
Profits from Current Production ($B)*	199.8	209.0	223.0	232.8	237.8	243.4	248.5	255.7	149.4	197.2	234.3	256.1
GOVERNMENT FISCAL POLICY ($BILLION)**												
Unified Budget – Receipts									601	666	745	810
Unified Budget – Outlays									796	842	955	1010
Unified Budget – Federal Surplus or Deficit									-195	-175	-210	-200

*Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revised estimates of the national income and product accounts for the fourth quarter of 1984. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government outlays of $17 billion in calendar year 1986. The money supply, as measured by M(1), is expected to grow by 6.5% in 1985 and 6.9% in 1986. Continued weakness in crude oil prices is expected to result in a reduction in the OPEC marker price to $26 per barrel in 1986. The federal minimum wage is assumed to remain at $3.35 an hour throughout the forecast interval. The lackluster performance of the European economies relative to the United States is expected to continue to support the dollar in the near term. The trade weighted exchange value of the dollar is anticipated to rise by 4.8% in 1985. Thereafter, the mounting trade deficit and declining interest rate differential, as well as a strengthening of foreign demand, place downward pressure on the dollar, contributing to a 4.5% devaluation in 1986.

have serious negative implications for the U.S. economy. Studies show that such legislation would have no long-term impact on the current account deficit, which it is intended to resolve. It would, however, likely result in retaliatory measures by our trading partners which will severely restrict our export performance. Indeed, the European Parliament has already passed a resolution calling for retaliation should an import surcharge be imposed on all imports into the United States. The surcharge would also cause a serious inflationary shock on the U.S. economy whose magnitude is a function of foreign exporters' willingness to absorb a part or all of the price increase resulting from the imposition of the tariff. Interest rates would also rise as inflationary expectations rebound. The imposition of further restrictions on trade is a clear recipe for disaster.

As detailed in the previous article and the one that follows, fiscal policy outcomes will also have an impact on the overall outlook. In particular, the failure to address the federal deficit problem through significant reductions in the rate of growth of federal spending could result in tax increases which would depress economic activity.

In sum, our forecast continues to anticipate quarterly rates of real GNP growth in the five percent range during 1985, leading to year over year growth rates of 4.6 percent in 1985 and 4.8 percent next year. Inflation is expected to remain subdued and average 3.4 percent and 3.7 percent respectively, this year and next.

FISCAL BEFUDDLEMENT AND THE FEDERAL BUDGET

by

Ronald D. Utt

Senate Republican efforts to make dramatic progress against deficit spending have apparently bogged down, as many in Congress refuse to accept the kind of cuts needed to pare government spending by $50 billion or more in the next fiscal year. With deficits projected to exceed $200 billion per year for the remainder of the decade, the $50 billion in proposed cuts would be required just to restore the deficit to the level it hit last year. Even more will be required if the target of reducing the deficit to four percent of GNP is to be achieved.

The new budget season got off to a good start in early February when the President presented his FY 1986 budget proposal. It, too, proposed cuts of $50 billion, but focused its spending restraint proposals on programs other than defense and social security. Counting interest payments on the debt, this left about two-thirds of the budget largely untouched and forced the Administration to make dramatic cuts in the remaining one-third in order to achieve the needed $50 billion in reductions. Included in the proposal was a five percent pay cut for all federal civilian workers and termination of nearly twenty five programs, including general revenue sharing, Export-Import Bank loans, the Small Business Administration, AMTRAK, and Urban Development Action Grants. Many other programs were to be continued but at a greatly reduced level. Howls of pain and suffering were heard throughout the land as one constituency after another had its ox gored and served up as shish kebab to the cause of deficit reduction.

In contemplating the likely constituent reactions to such a proposal, Congress couldn't help but conjure up images of Little Bighorn, the Alamo and other lost causes in which there were no survivors. Unlike Custer and Crockett, however, members of Congress possess acute survival instincts. Fearing the emergence of a no prisoners policy among their constituents, some went to work on alternative approaches consistent with their long-term career goals, while others took the ox by the horns and tried to craft a package that achieved dramatic cuts in every area of spending. The first to hit the chopping block was Mr. Weinberger's defense budget. The Department of Defense wanted a $32 billion spending increase—an eleven percent gain over this year's spending level. Inasmuch as defense spending has doubled since 1980, many in Congress figured that we could easily afford a one-year pause in the build up and recommended a freeze in defense budget authority. A one-year budget authority freeze would save somewhere between $15 and $20 billion dollars in 1986 and approximately the same amount in subsequent years as future defense budgets resumed growth from a lower base.

The next sacred cow to be dragged up to the altar was social security and its system of automatic cost of living adjustments (COLAs). Although the President made a firm promise during the campaign not to make any cuts in the program, many in Congress were not so encumbered and began to look closely to see how much could be saved through a one-year COLA freeze. Plenty, as it turned out. Savings would amount to about $7 billion in 1986 and almost $10 billion in each of the subsequent years. While the elderly squealed at the prospect of losing their automatic increase for one year, and their representatives in Washington commissioned a study to quantify the suffering this would cause, these members persisted in keeping the COLA freeze on the front burner, so to speak. Perhaps this reflects the growing realization that the elderly are no longer the impoverished group that folklore suggests. Indeed, recent reports from the Census Bureau indicate that our typical elderly citizen is better off than the rest of us. The incidence of poverty amongst those over 65 years of age is about one-third that of the population as a whole after taking into account all benefits going to the elderly, and the after-tax, per-capita income of those over 65 is $335 higher than that for the population as a whole.

By adding the changes in Defense and Social Security to their prospective budget, the Senators achieved an additional $16 billion in savings to apply against the FY 1986 deficit. Alternatively, this amount could be used to soften the President's proposed cuts and still reach the $50 billion target. Or, at least, that is what the plan, as developed by Senators Dole and Domenici, envisioned. But "Twixt cup and lip..." as the proverb observes; momentum was lost as members of Congress struggled to maintain funding for preferred programs, which seemed to include virtually everything now in the budget. The ambitious schedule that was established–a full-blown proposal by the end of February with Senate Republican backing, followed by a vote of the full Senate in late March–went with the wind, and staffers close to the process have no guess as to when we will see a budget and what will be in it. Meanwhile, in the House of Representatives, members have temporarily retired from worrisome budget deliberations, deciding instead to watch how things play out in the Senate.

And so the struggle goes on and the fiscal imbalance worsens. In late February, the U.S. Treasury released budget figures for the first four months of the 1985 fiscal year. It paints a grim picture of the failure to come to grips with deficit spending and illustrates how runaway spending is driving the deficit higher and higher. So far this fiscal year, the deficit is running $10 billion above last year's level, propelled upward by a 12.4 percent increase in spending. This is more than twice as fast as spending grew in the last fiscal year, three times the rate of inflation and a third faster than the economy's growth rate. As a result, federal spending is expected to rise to a 24.5 percent share of our gross national product, the second highest peacetime share on record and just 0.2 percentage points less than the all-time record set in 1983.

The culprits involved in this orgy of spending are easy to find. Outlays for agriculture are up 27 percent from last year, propelled forward by a 50 percent increase in the cost of commodity price supports. Interest on the debt runs a close second with an increase of 22 percent, largely as a consequence of the massive debt accumulation over the past five years. Medicare spending zips along at a 12 percent growth rate, even though the eligible population has increased by only 1.4 percent, while the Environmental Protection Agency is spending at a rate 16.8 percent faster than last year. In all fairness, many programs are reduced from last year's levels, but these cuts did not offset the large increases elsewhere.

The Administration's budget proposal makes a compelling case for the many cuts and terminations it proposes. In proposing to terminate the AMTRAK subsidy, which would save $2.2 billion over the next three years, the OMB notes that the system handles only two percent of the intercity passengers at an average subsidy of $35 per rider. On three routes–New York/Boston, Chicago/New York, and Portland/Seattle–the subsidy is so large that it would be less costly for the government to end the train service and pay the full price of bus or plane fare for each and every AMTRAK passenger on these routes.

Revenue sharing, a program to transfer funds from federal to state and local governments, is also proposed for termination at a savings of $4.5 billion a year. It was originally started at a time when the Feds had a projected surplus of funds while the state and local governments were strapped for money. That situation has changed. Last year, when the federal government ran a deficit of $175 billion, state and local governments ran a surplus of $52 billion.

Spending on agriculture, mostly price supports, continues to soar out of control. In spite of, or more likely, because of, fifty years of intense and expensive involvement by the federal government, parts of our farm sector are confronting severe economic stress. Falling incomes at the less efficient farms have made it impossible for these farmers to maintain their debt service obligations. Some have been forced into bankruptcy while others are insolvent and likely to follow suit. Despite $16 billion of federal farm assistance last year and another $21 billion in 1985, the situation has only worsened. Expressed another way, each American household has to cough up an extra $247 in taxes this year to subsidize agriculture. This, of course, does not include the cost of higher food prices created by the commodity price support system and the effect this has on government food stamp costs.

Recognizing that fundamental reform is needed if this problem is to be solved once and for all, the Administration has proposed a bold plan that would restructure and strengthen our agriculture economy while saving the taxpayers a bundle in the process. Under the President's plan, spending for agriculture would be reduced by $27 billion over the next three years in a market-oriented restructuring of the commodity price support program.

Congress, however, seems likely to reject this approach and is now in the process of enacting legislation that will *increase* federal farm spending. This month, the Senate and House of Representatives passed a farm credit bailout bill that will add about $7.4 billion to this year's deficit. Assuming that they also reject the President's proposed farm program reforms, which the Senate Budget Committee has already done, 25 percent of the savings in the President's deficit reduction package will be lost.

And so it goes as the lines of battle are drawn over each and every proposed spending cut. Almost $12.8 billion of potential savings could be lost in agriculture. More than $4 billion could be lost if cuts in revenue sharing are rejected. At this point, the $50 billion in savings has been whittled down to $33.2 billion by the preservation of just two programs. Fearful of angering the elderly, Congress might also reject the $4 billion savings proposed for Medicare and the three-quarters of a billion in cuts for civil service retirement. Now the savings are reduced to $28 billion, and falling as more and more programs are held harmless. And so it goes.

As of early March, Senator Domenici is struggling to put together a package of budget cuts totalling $64 billion, the amount needed to bring the 1986 deficit down to four percent of gross national product. So far, constituent pressures are ripping the package apart and he is unable to get even his Republican colleagues behind the effort.

If the Senator fails, events will likely move in one of three directions: One, most budget cuts will be in defense, thereby jeopardizing our national security without making much progress against future deficits; two, Congress might try to pass a big tax increase, thereby jeopardizing our economic growth potential for the rest of the decade; finally, Congress might try a combination of the two, leaving us with the worst of both worlds – a kind of Jimmy Carter Redux; and we all remember how much fun that was. These are the risks we confront if Senators Domenici and Dole fail in their efforts to enact a comprehensive program of substantial reductions in spending.

EUROPESSIMISM: FACTORS UNDERLYING WESTERN EUROPE'S ECONOMIC DECLINE

by
Graciela Testa-Ortiz

One of the characteristics of current global economic conditions is the lack of synchronization among the recovering economies; in particular, the extent of the lag between the recovery of the Western European nations and that of the United States and Japan. During the first year of recovery (1983), the only European nation to experience a rate of economic growth comparable to that of the United States was the United Kingdom. West Germany, long seen as the engine for European growth, achieved a rise in real gross domestic product (GDP) of only 1.3 percent that year. The French and Italian economies weakened in the face of fresh austerity measures, which in the case of France were necessitated by the Socialist excesses of 1980-81.

The performance in 1984 was even more disheartening. The United Kingdom and West Germany saw growth rates of only two percent and 2.5 percent, respectively, as domestic labor unrest contributed to significant production losses. Italy put in the best performance of the lot, growing by three percent. And France came in at only 1.8 percent. With the exception of the United Kingdom, the outlook for this year is generally considered optimistic. Unfortunately, this optimism translates into rates of growth for the four major economies which range between two and three percent – not very encouraging prospects, particularly when compared to the expected performance of the United States, Japan, and the East Asian and Pacific Basin nations (see Table 1).

TABLE 1
REAL ECONOMIC GROWTH, 1982-1986
(percent change)

	Actual			Forecast	
	1982	**1983**	**1984**	**1985**	**1986**
West Germany	-1.1	1.3	2.5	2.7	2.8
France	2.0	0.7	1.8	2.0	2.0
Italy	-0.4	-1.2	2.9	2.7	2.0
United Kingdom	2.5	3.2	2.0	2.9	2.8
Smaller European Countries	0.8	1.6	2.5	2.5	NA
United States	-2.1	3.7	6.8	4.6	5.1
Canada	-4.4	3.3	4.8	2.5	2.9
Japan	3.3	3.0	5.8	4.6	3.6
East Asia[1]	NA	6.8	5.8	4.2	4.6
Australia	0.7	0.6	6.1	2.8	2.2
Latin America[2]	NA	-2.6	1.8	1.9	2.9
Africa[3]	NA	-0.6	-0.8	2.2	3.4
Middle East[4]	NA	-10.1	0.6	6.0	7.6

[1] Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand.

[2] Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Venezuela.

[3] Algeria, Morocco, Nigeria, South Africa.

[4] Egypt, Iraq, Kuwait, Saudi Arabia.

Source: Organization for Economic Cooperation and Development, Data Resources, Inc., The Economist Intelligence Unit.

Until recently, domestic demand has not provided any support to the European economies. The meager growth that they have experienced thus far is derived from the strength of foreign demand, which in the case of West Germany, for instance, accounts for as much as thirty percent of domestic production. British exports to the United States rose by 17 percent in 1984, while German and French exports to this country increased by about 35 percent. This rise in exports to the United States is more strongly related to the strength of U.S. demand, than to the appreciation of the dollar.

In spite of the surge in exports, it appears that some European nations have been unable to benefit from the slide in the exchange rate of their currencies against the dollar and the price advantage that it should provide. For instance, between 1981 and 1983, sterling declined 39 percent against the dollar and almost 19 percent against other major currencies. Nevertheless, British exports rose by only 19 percent, while imports increased by 30 percent. A survey by the Confederation of British Industry shows that while exports of unique products and luxuries, such as Jaguar cars and Wedgwood china, are booming, traditional exports are doing rather poorly. Reflecting this, Britain's share of world exports has declined from ten percent in 1975-81 to 8.5 percent in 1981 and 7.9 percent in 1983. France faces a similar problem. The balance of trade gap was reduced by one-quarter between 1982 and 1984; however, this was achieved by a boost from strong sales of cereals, Airbus contracts and Arab orders for French weapons. Traditional manufacturing exports, on the other hand, remain weak. Italy has also suffered from an imbalance in its exports resulting from the foreign exchange performance of the lira. While the lira continues to fall against the dollar, it has remained strong against most other European currencies. When combined with the high costs of production in this nation, the result is that Italian exports to the U.S. have done reasonably well, but its trade deficit with the EEC has risen.

Changes in the sterling exchange rate should have served as a stronger stimulus to British exports. A recent OECD (Organization for Economic Cooperation and Development) study concludes that the reason for the lackluster performance relates to comparatively high labor costs in Great Britain. For instance, in the year to November, manufacturing wages were rising by 8.5 percent, placing Great Britain at a cost disadvantage relative to other exporters. Labor costs in West Germany, France, and Italy, on the other hand, have remained relatively stable, and, as in the United States, have made a major contribution to the moderate rates of inflation now being experienced. In France, wage increases fell below price increases in 1984 after rising by eleven percent in 1983. The inflation rate has declined from 13.3 percent in 1981 to 6.7 percent last year, the lowest inflation rate in twelve years. Nevertheless, both wages and prices in France are still rising faster than the OECD average, even though France has been successful in reducing wage indexation. Italy, on the other hand, continues to labor under the scala mobile (a system of indexing wage scales to inflation), although it is becoming increasingly apparent that it must be changed.

With the exception of Italy, domestic demand in Europe, particularly in the consumer sector, remains weak. A turnaround is now apparent in the investment sector, which began to perk up as business confidence improved. However, recent increases in interest rates in Great Britain and West Germany, which were geared towards supporting domestic currencies, may very well dampen the strength of this sector in those countries. In the U.K., the clearing banks' base rate rose from 9.5 to 10.5 percent on January 11th, and then again to 12 percent three days later. West Germany raised the Lombard rate 50 basis points to six percent. France and Italy, on the other hand, have actually reduced interest rates. In France the base lending rate was reduced by 50 basis points to 11.5 percent in January.

Unemployment remains Europe's intractable problem. With economic growth projected at moderate rates, these nations will be unable to stem the upward drift in joblessness. The numbers surrounding the employment situation mirror Europe's structural problems. Approximately one out of ten Europeans is currently unemployed. In Britain, the unemployment rate reached 13 percent in January, and the situation in some of the smaller European nations is even more dismal. While the unemployment rate in France averaged 9.3 percent in 1984, below the U.K. and Italy, it rose to 13.6 percent in January 1985, and is rising faster than in other OECD nations. In Spain, the official jobless rate reached 20 percent last year. What is even more disheartening is the trend towards long-term unemployment. In Britain, 40 percent of those unemployed have been out of work for more than a year. Some of the measures enacted to reduce unemployment have done more harm than good. France, for instance, opted to reduce the work week and lengthen holiday periods. This has increased labor costs but has had no visible impact on the employment situation.

TABLE 2
COMPARATIVE UNEMPLOYMENT RATES
(percent)

		Actual			Forecast	
	1970s Average	1982	1983	1984	1985	1986
West Germany	2.3	6.7	8.2	8.4	8.4	8.4
France	3.7	8.0	8.2	9.3	10.5	11.0
Italy	6.3	9.1	9.7	10.0	10.5	10.8
United Kingdom	4.7	11.0	11.5	11.8	11.8	11.8
Smaller European Countries	NA	10.7	12.2	12.8	13.3	NA
United States	6.1	9.7	9.6	7.5	6.8	6.2
Canada	6.6	11.1	11.9	11.5	11.5	11.5
Japan	1.7	2.4	2.6	2.8	2.5	2.5

Source: Organization for Economic Cooperation and Development.

Why is the European economy stagnating? Why has it been unable to create jobs? What is the explanation for Western Europe's unaccustomed status as the world's laggard?

Bad Policy is One Reason

The role that the public sector plays in the European economy offers one explanation for its current stagnation. Europeans have increasingly looked to the state to provide basic services which are best left to the marketplace. As a result, the tax burden in Europe is significantly higher than in the U.S. or Japan. During 1982, taxation averaged 44 percent of gross domestic product in West Germany, France, Italy and Great Britain. Although many attempts have been made to increase incentives through reductions in tax rates, these reductions have generally been nullified by indirect tax increases, such as levies on gasoline.

These revenues help to support a bloated public sector which accounted for an astounding 46 percent of GDP in 1982. A large proportion of the region's public spending is in the form of social programs such as jobless compensation, which in their generosity, may well contribute to extending the length of unemployment. Between 65 and 95 percent of the previous wages of the unemployed are currently being paid by the state, effectively removing the urgency of searching for alternative employment that the jobless population should feel. Indeed, this is one of the greatest criticisms of the British benefits system. For instance, some benefits are higher for families with children, while wages, of course, make no distinction as to family size. A step in the right direction was taken in 1981 when unemployment benefits became taxable. However, an important disincentive remains in the form of the supplementary benefit used to raise the income of the working poor. Once the income of a person receiving supplementary benefits reaches a certain level, the benefits are removed on a pound for pound basis. This is the equivalent of a marginal tax rate of one hundred percent.

The social security system adds an incredible burden to businesses everywhere in Europe and further raises the cost of hiring additional workers. In Spain, for instance, social security payroll taxes amount to 30 percent; however, the employees' share of the total tax burden is 13 percent, while the employer pays the remaining 87 percent.

A host of labor regulations throughout Europe inhibit labor mobility. It is virtually impossible to fire anyone, even for economic reasons. To do so, a company has to obtain government approval, a lengthy process at best. They may also be faced with industrial tribunals or expensive unemployment compensation payments. Minimum wage legislation and other restrictions on wage flexibility also exist. In the effort to provide job security, one basic factor of economic life has been lost; namely, an innovative firm must be able to hire and fire workers quickly as demand patterns change. As a result, firms are reluctant to hire new workers when demand rises, since it would be extremely difficult to lay off these workers in times of slackening demand.

Bankruptcy laws are similarly restrictive; bankruptcy is still looked upon as a moral weakness. However, a relatively large number of bankruptcies, even in periods of economic recovery, reflects the workings of a competitive economy and a developed venture capital market that allows for a host of different products and ideas to be tested. Many of the new companies die off fast, but the survivors grow into large firms just as rapidly. The ability of firms to enter and exit the market is a major characteristic of a strong market economy.

The Uncommon European Market

The European Economic Community (EEC) was created 27 years ago to provide the member nations with an integrated market whose size, with a population of 350 million people, would rival the U.S. market. Unfortunately, it has yet to reach its objective of serving as a stimulus to European unity and progress. Moreover, at times it seems hobbled by nationalistic self-interest. The Community has become a caricature of itself: an uncommon market perpetually embroiled in bickering over agricultural issues and absurd discussions. Witness, for instance, the recent debate over whether or not to require that all dogs and cats in the member countries have identification numbers tattooed on their ears.

One of the most persistent problems within the Community, one which it was established to solve, is the immobility of resources – labor and capital – across national frontiers. For instance, a truck driver going from West Germany to Italy has to fill out 27 forms to get through customs. In fact, it is estimated that border delays cost Europe $10 billion a year.

The lack of standardization is also rampant. It affects everything, from telecommunications to university degrees. For instance, telecommunications equipment makers can only look to their home market, not to the European market, as a source of demand because of different standards across countries. National favoritism has many faces. One manifestation of this is that virtually all the member nations want to produce critical equipment rather than concentrating production with those companies and countries which enjoy a comparative advantage. For instance, digital telephone switches were produced by ten companies in western Europe (compared to two in Japan, and three in the U.S.). Consequently, these companies can only sell their equipment in their home markets rather than the entire European market. The EEC has also contributed to the creation of several cartels which increase costs and limit competition. The airline cartel is a case in point.

Europe's preference for large, established companies is also a disadvantage. Because of it, the small entrepreneurial firms, those which generate the largest source of new jobs in the United States and Japan, get little encouragement in western Europe. Instead, virtually every European economy is strapped with decaying smokestack industries that must be heavily subsidized. In attempting to break this pattern, Great Britain has taken major steps in the privatization of nationalized industries. Sixteen companies were denationalized between 1979 and 1984 in industries ranging from oil (British Petroleum), to sugar (British Sugar Corporation), to cars (Jaguar), to telecommunications (British Telecom). With the exception of oil, all the denationalized industries have outperformed the market in terms of price per share.

The High-Tech Gap

Another major concern is Europe's inability to compete with the U.S. and Japan in high technology industries, in particular, the poor performance of the European information industries. The European computer market, for instance, is still dominated by IBM. Only this month have the six European computer makers announced that they have adopted a common operating system, the first step towards standardization of European information technology. American companies also dominate the software end of the business, accounting for 87 percent of the personal computer software market in France, for instance.

The weakness of the European nations in the information field is a symptom of a more far-reaching ailment; namely, the lack of an economic environment geared towards innovation. The roadblocks faced in this area apply to the entire European economy as well as the information industries. Innovative European firms labor under sometimes insurmountable burdens – the uncommon common market being the prime example. Far from being an integrated market, the European community places crippling burdens on the development of new products and technology. Testing and certification requirements, differing standards, and border delays all take their toll, adding as much as 20 percent to the cost of intracommunity trade.

But rather than creating the type of unfettered business environment that would foster the development of Europe's still infant venture capital market which the high-tech firms require, the EEC is instead going in the direction of more government spending. The lack of an established venture capital market is a major problem for the high-tech industries. While America's venture capitalists provide an efficient mechanism for launching small firms, Europeans rely on the use of government subsidies instead of market-based capital to finance small firms.

The recent creation of the European Strategic Program for Research in Information Technology (ESPRIT), is a case in point. If anything, this seems a recipe for disaster. It runs the risk of becoming another Airbus, with taxpayers in all member countries contributing many billions of dollars in the support of an enterprise that would best be accomplished in the private sector. The technology and information industries do not need greater government spending, but the removal of existing barriers, as for instance, the fact that university degrees are not necessarily valid from one country to another.

Government spending, far from an advantage, can sometimes turn into a hindrance, because it usually favors the domestic producer, instead of the most efficient EEC producer, as well as the big, established firms. For instance, some 80 percent of the British government's support of microelectronics has gone to five firms, with half of the total going to one firm alone. Consequently, this system denies the small entrepreneur the necessary access to funds. The dominance of large, established institutions is apparent in most of the European economy's leading sectors. The West German financial sector, for instance, is dominated by the six largest banks. These institutional arrangements discourage the emergence of risk-taking small entrepreneurs.

High-tech industries in the U.S. benefit from close relationships with universities; in fact, about seven percent of American university research is financed by industry. This is not the case in western Europe where universities are unable to compete for quality researchers. The problem arises from the fact that the salaries and resources available to the potential researcher have to be in line with that of other professors in the lock-step promotional system of many European universities. In such a position, it is difficult to woo new talent, and western Europe has been suffering a continuing brain drain.

Forging a tighter link between Europe's excellent research facilities and its industries is an urgent need, but one that is apparently difficult to fulfill. Again and again in the past few years, other countries have successfully brought products to market which were based on European-developed technology. Two Japanese auto firms are already testing cars with ceramic engines, although the West Germans are the acknowledged world leaders in ceramics research. Recently, the EEC placed heavy import duties on laser-operated high fidelity disc players to protect the domestic producers. It is ironic that they would need to protect this industry from import competition since the technology for the development of these disc players was pioneered by Philips in the Netherlands.

Western Europe, the Dollar and Capital Flows

It is impossible to discuss current conditions and prospects for the western European economies without touching upon the impact that the value of the dollar is having on these nations. By now, most everyone agrees that the main factor behind the dollar's appreciation is the strength of the U.S. economy vis-a-vis other major economies. Even Prime Minister Thatcher has offered this explanation for the dollar's strength. The past year has shown, conclusively we believe, that relatively high real interest rates in the U.S. are not the mainstay of the dollar (see last month's ECONOMIC OUTLOOK).

Nevertheless, Europeans, by and large, continue to complain vociferously about the negative impact of the strong dollar on their domestic economies. The argument goes as follows: A large U.S. federal government deficit results in high real rates of interest in the U.S. (never mind that this link has yet to be conclusively proven). Further, high rates of return for dollar denominated assets siphon investment capital away from the local economies to the U.S. And finally, in an effort to maintain the value of their currencies, the European nations need to raise domestic interest rates, thus dampening the recovery in their investment sectors.

As has been the case with many other truths which floated around during the past couple of years, the fact that the strong dollar is siphoning capital away from European investment does not stand up to scrutiny. While it is true that net foreign assets in the U.S. have risen strongly, the evidence shows that this increase is largely due to a decline in U.S. assets abroad rather than a massive influx of foreign funds into the U.S. Table 3 shows that foreign net capital flows have remained fairly stable since 1981. U.S. assets abroad, however, have declined dramatically. Furthermore, the table shows that the decline in U.S. assets abroad is largely due to a fall-off in private asset holdings, in particular, direct investment. The surge in U.S. investment during the current recovery was not, as some would have us believe, financed by an influx of foreign money, but rather by domestic investors who turned away from foreign capital markets in favor of U.S. capital markets. The implication is clear. The strength of the dollar may very well be the result of a decrease in U.S. demand for foreign currencies rather than an increase in foreign demand or dollars.

TABLE 3
U.S. CAPITAL FLOWS
(billions of dollars)

					1984	
	1981	1982	1983	I	II	III
Changes in U.S. assets abroad (net capital outflow)	111.0	118.9	49.5	2.0	19.0	(16.0)
Gov't & Official reserve assets	10.3	11.1	6.2	2.7	1.8	2.3
Private assets	100.7	107.8	43.3	(.7)	17.2	(18.3)
Changes in Foreign assets in the U.S. (net capital inflow)	81.3	95.2	81.7	15.7	40.4	6.2
U.S. Treasury securities	8.0	12.8	8.7	1.4	6.5	5.2

[1] Negative values (in parenthesis) indicate a net inflow (disinvestment).

Source: *International Economic Conditions,* Federal Reserve Bank of St. Louis, August 1984 and January 1985. *U.S. International Transactions, Survey of Current Business,* December 1984.

Unfortunately, the line of reasoning that goes from the U.S. budget deficit to Europe's current economic woes via the strength of the dollar leads to policy prescriptions that would stymie the global recovery. Namely, that the U.S. must reduce the size of its federal budget deficit so that domestic interest rates, and thus, the value of the dollar, can decline. The argument misses the major factor behind the dollar's strength, that is, the prospect for sustained, noninflationary growth of the U.S. economy. Indeed, a reduction in the size of the U.S. deficit might well be interpreted as enhancing those long-run prospects, thereby making the United States an even more attractive place to invest, and pushing the dollar to new heights.

Conclusion

What is really going on here is that the European nations have been unable to revive their economies. Further, in some cases, they have been unable to benefit from the depreciation of their currencies because of relatively high labor costs (as detailed above in the case of Great Britain). The only long-run option available is the revival of the western European economies. That can only be accomplished by removing the roadblocks to strong economic growth mentioned in this report.

This includes restructuring labor and bankruptcy laws (as detailed above), which raise costs of production and place Europe at a competitive disadvantage with the rest of the world. Secondly, the tax burden in Europe is too high. The tax burden in the European members of the OECD has risen from 32.7 percent in 1962 to 45.7 percent in 1982, compared to a five percentage point increase in the U.S. At the same time, real GNP growth has fallen from an average of 4.5 percent in 1964-1974 to 1.8 percent between 1974 and 1982 (see *International Perspectives on Tax Policy and Economic Growth,* ECONOMIC OUTLOOK, October, 1984). Finally, western Europe needs to devote more of its resources to promoting entrepreneurship and its high technology industries, or risk never being able to catch up with the U.S. and Japan in this area.

EAST ASIA ON THE MOVE

by
Rajni Bonnie Ohri

Recently, the countries of East Asia have been reaping the benefits of the current economic expansion in the U.S. A look at the growth rates of eight nations in that region (Taiwan, Singapore, Hong Kong, South Korea, Indonesia, Malaysia, Thailand, and the Philippines) shows seven of them booming with only the troubled Philippine economy lagging behind. In table 1, the top four countries, the newly industrialized countries (NICs), lead the region in growth: Singapore, Hong Kong, Taiwan and South Korea. These countries depend heavily on exports of manufactured goods, and over the past year, their exports to the U.S. have soared. In addition to their domestic and regional markets, these countries also have strong trade ties with many other nations, notably Japan.

TABLE 1
EAST ASIA'S REAL GDP GROWTH
(percentage increase)

	1983	1984*	1985*
Singapore	7.9	9.0	7.6
Hong Kong	5.2	8.3	6.5
Taiwan	7.2	10.2	7.4
South Korea	9.3	8.3	7.2
Indonesia	5.0	4.7	5.1
Thailand	5.8	5.9	6.0
Malaysia	5.8	6.4	5.9
Philippines	1.3	-4.2	0.7

*Estimate

Source: International Monetary Fund, Chemical Bank, Citibank

East Asia's economic record stands distinctly apart from other developing regions where accelerating inflation, huge debts, and economic stagnation dominate events. Free market nations in the region boast sustained economic expansion, with living standards on the rise and bright prospects for the rest of the decade. Even troubled Hong Kong – depressed by the prospect of China's taking control from Britain in 1997 – has factories running full blast and exports booming. Only in the Philippines do things march backward, with national income unlikely to rise this year. But the progress in the other nations is astounding. Measured in per capita terms, Singapore, for example, is now wealthier than Ireland and is gaining fast on Italy. Taiwan, a nation of 19 million people, exports more than Spain, a nation of nearly 40 million. Tiny Hong Kong, destitute at the end of World War II, now has more Rolls Royces per capita than any other country.

And the boom continues. While West Germany moves to reduce its workweek to 38.5 hours, Hong Kong works Saturdays. While France's President Mitterrand toured the Silicon Valley last year and pronounced himself a venture-capital convert, Taiwan's low-tax, high-tech industrial park near Taipei was entering its sixth year. While most of Europe will be lucky to record three percent growth for last year, South Korea expects eight percent or better.

The Asian Advantage

In contrast with the stagnation that plagues America's traditional partners in Western Europe, dynamic growth is the hallmark of most of the countries in this sweeping Pacific arc. East Asian nations, which not long ago were counted among the most backward, are emerging as dramatically expanding markets as well as tough competitors for the U.S., Japan and Europe.

The implementation of growth-enhancing development policies has been the reason behind this region's success. These nations are proving that private enterprise and free market forces determine the best use of resources and that national development depends on entrepreneurial vigor and economic incentives. Over the past decade, the average compounded growth rate in these countries has been nearly eight percent – roughly three times that of the nations of the European Community and almost twice that achieved by all developing countries (see chart 1). For the group as a whole, GDP (gross domestic product) growth declined to less than five percent per annum during 1980-83, still a respectable performance compared to the rest of the world. In overcoming the obstacles of economic growth, these countries followed an approach that can be broken down into five key elements.

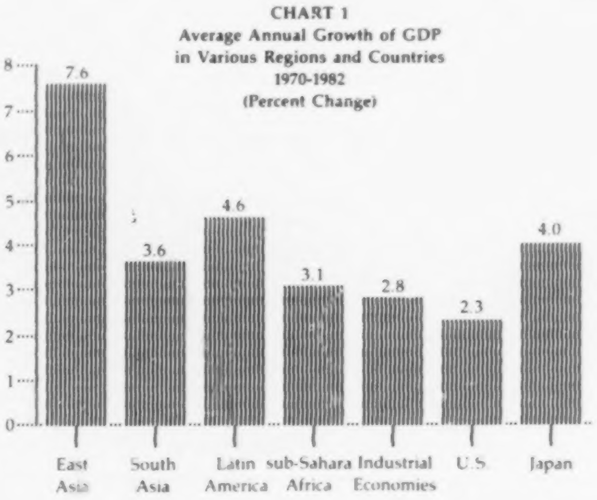


CHART 1
Average Annual Growth of GDP
in Various Regions and Countries
1970-1982
(Percent Change)

First, in contrast to common notions about development, the East Asian countries have financed much of their growth with domestic saving and investment. Neither developing nor developed economies can grow over the long term solely on the basis of savings borrowed from abroad. Adequate incentives for domestic production, saving and investment are at the heart of effective policies for sustained growth. The East Asian countries have provided these incentives and generated impressive savings rates.

In 1981, according to World Bank figures, Americans saved about 18 percent of their GDP. In contrast, the Thais saved over 20 percent of their GDP; the Malaysians from 20 percent to 26 percent; and the Singaporeans from 28 percent to 33 percent. The most dramatic increase in domestic savings rates has been in Korea (from 1 to 22 percent between 1960 and 1982) and in Indonesia (8 to 23 percent during the same period). In 1981, these domestic savings financed over 80 percent of gross domestic investment for each of the East Asian nations.

Second, the East Asian countries have used foreign assistance to supplement their domestic saving. Aid wisely used as it has been in this region can be a helpful boost to domestic saving. Past U.S. aid, to Taiwan and Singapore, for example, helped create the infrastructure which made economic growth possible. The economic and political stability of these countries has also provided the incentive for investors to keep funds within the region.

Third, the region has generally welcomed foreign investment. Such investment brings with it wider markets and transfers of technology. Foreign investment has been an important source of information on new products, designs and production processes. It also earns its own return rather than creating a fixed debt-service obligation. Currently, the Philippines has a temporary window open to 40 percent foreign equity, and Singapore and Hong Kong have virtually no restrictions on investment. However, Malaysia, for social reasons, has investment requirements that favor its indigenous population, but otherwise maintains an open door to foreign investment. In contrast, investment in Indonesia can be a challenge to foreign firms wanting more than 49 percent equity. Indonesia requires, among other things, that upward of 20 percent of the employees of foreign invested firms be ethnic Indonesians.

The fourth element in the East Asian "high road" to development is its reliance on trade as the engine of development. These countries have developed their export industries efficiently under healthy competition from imports. Exports account for over 45 percent of the combined GNP of these nations. The outstanding success of Korea in exporting manufactured goods is well recognized. But exports of manufactured goods from the Philippines, Malaysia and Thailand have also risen at rates averaging 20 to 30 percent per annum for a decade. Even in Malaysia, where exports of petroleum, timber, rubber, and palm oil have risen dramatically, manufactured exports have accounted for about 35 percent of incremental export earnings over the past decade. Fortunately, manufactured exports from these East Asian countries have held up relatively well during the recent recession, expanding at an average annual rate of 13 percent during 1980-83, compared with five percent for developing countries as a whole.

Although some East Asian countries have erected trade barriers to imports, they have been less restrictive than other developing countries. These nations have relied on liberal trade as the primary engine of development. In contrast, Latin American countries have concentrated on import substitution behind high tariff walls.

Thailand, which protects infant industries, has tariffs in the 30 to 60 percent range. The Indonesian government, in an effort to capture technology and increase employment, requires that trade be conducted through licensed importers, and has designated 120 products that can be imported only through state-owned trading companies. The Korean government also has placed restrictions on some 83 percent of the products it imports and in general, bans certain goods completely, such as foreign cigarettes. These various protectionist barriers are a blot on the region's otherwise good record of liberal trade.

Fifth, the East Asian countries in recent years have adhered to prudent monetary and fiscal policies. These policies have resulted in generally well-structured debt and manageable debt-service payments as a proportion of foreign exchange earnings. Singapore's record in this respect is exceptional: its long-term and medium-term debt-service ratios are under one percent of exports and short-term public debt is essentially private, self-liquidating trade paper. With the exception of the Philippines, other nations in the region have also done well. Indonesia, for example, has a debt-service ratio of about 22 percent and Thailand's is 15 percent; this compares favorably to the debt ratios of some Latin American countries which are close to double these figures (35 percent for Brazil and 30 percent for Argentina).

In sum, the region's road to growth is based on an "open up" rather than a "close out" philosophy. The exports of these countries have surged primarily through trade with the rest of the world, not with each other. The outward looking, market-oriented economies of the region have become models of development. In addition, although there has been government intervention in the private markets, it has worked with the market in a supportive manner. Their remarkable success is persuasive evidence that private enterprise and market forces, not state ownership, is the best engine of rapid economic growth.

U.S. Stake in East Asia

Predictably, the competitive threat from the East Asian countries has drawn a sharp backlash from some of the developed nations. In 1983, U.S. trade with the East Asian region reached $136 billion—exceeding by $26 billion bilateral trade with Europe. U.S. exports to the East Asian region have grown 1200 percent since 1960, surpassing by far the growth of U.S. trade with other areas of the world. East Asia has supplanted Western Europe as the number one foreign market for U.S. agricultural exports, accounting for nearly one third of total sales. The major U.S. exports to the region include grain, lumber, chemicals and civilian aircraft. Of America's 20 largest overseas customers, eight are in the East Asian region.

In its bilateral trade with the region, the U.S. sells more than it buys in only one broad category of goods: food, feeds and beverages. And, it's not surprising that, in agricultural goods, the U.S. has an edge, in view of the high ratio of population to arable land in this country. But in every other category, East Asia comes out ahead. These countries not only dominate the consumer goods sector but also run bilateral trade surpluses in industrial supplies, autos and capital goods. It might be expected that in capital goods production, which is usually a capital-intensive operation, the U.S. would hold a substantial edge over a region where labor is abundant and capital is scarce. But it appears that, on the whole, the region buys most of its capital equipment from Japan, which enjoys a competitive price advantage over the U.S. In total bilateral trade with the region over the first eight months of 1984, Japan had a surplus of $2.5 billion while the U.S. ran a deficit of nearly $17 billion.

Taiwan's exports comprise over half of its GNP, 40 percent of which (about a quarter of its GNP) were destined for the U.S. market in 1984. Last year U.S. imports from Taiwan mainly consisted of electronic goods and textiles. The biggest surge has come in sales of computer accessories, including terminals, disk drives and printers. In Hong Kong, leading exports to the U.S. consist of consumer products such as toys, clothing and watches. Singapore's exports to the U.S. rose 52 percent in the first eight months of 1984, consisting mainly of garments and electrical machinery. As a rule of thumb, it appears that every one percent increase of U.S. national income generates about a six percent rise of total NIC exports to the U.S. The recent strength of the U.S.economy is one reason why exports to the U.S. from this region rose so sharply in the first eight months of 1984. As table 2 shows, there has been no comparable rise in U.S. exports to the entire region.

TABLE 2
EAST ASIAN TRADE WITH U.S.
(annual rate of change, percent*)

	Exports to U.S.	Exports from U.S.
Taiwan	44.4	15.6
Singapore	52.2	-10.6
Hong Kong	32.3	18.4
South Korea	39.5	4.0
Malaysia	41.2	16.0
Thailand	44.6	23.2
Indonesia	13.6	-16.1
Philippines	27.3	-0.9

*First eight months of 1984 compared with same period of 1983

Source: Citicorp

In Malaysia, Thailand and Indonesia, real growth was also high this year, but not as high as in the NICs. In these countries, production for export does not represent so large a share of total output, so the growth of their exports to the U.S. has not given them such a powerful boost. What's more, they export chiefly primary commodities, whose performance has been mixed this year. Falling oil prices have cut Indonesia's earnings. The primary Philippine exports are sugar, coconut products and copper concentrates, while Thailand's include rice, rubber, tin and maize. All of these are subject to world price fluctuations. For the region as a whole, there have been large gains in sales to the U.S. of consumer goods – electronic and electrical appliances, apparel, toys and other labor-intensive products – reflecting the prevalence of relatively low labor costs.

Sustaining Open Trade

The burgeoning trade relations between the U.S. and East Asia are under attack from protectionists in the developed and less developed countries. The rapid escalation of trade flows inevitably creates frictions as foreign competition pressures less competitive producers to meet the overseas challenge. The debate over U.S.-Asian trade in this area centers around the question of relative market access. Many critics claim that East Asian markets are largely closed to U.S. goods because of high tariffs, tax policies, restrictions on investment, regulatory practices, quotas and other barriers. Consequently, these critics advocate that the U.S. retaliate by closing its markets or by implementing more restrictive trade laws.

East Asian barriers and alleged unfair trade practices which are most often cited include: subsidies (government offering cheap capital to uncompetitive industries) as seen in the Philippines (steel and mining) and Malaysia (services and autos); nationalization (common government run sectors include steel, airlines, shipbuilding) as seen in Korea and Taiwan; dumping goods in the U.S. below production costs (alleged violations by the Koreans in T.V.s and footwear); performance requirements (restrictions placed on foreign investment that require that a fixed amount of output be exported) as done in Indonesia and the Philippines; intellectual property violations (pirating and counterfeiting) as evident in the Hong Kong garment industry; and other market distortions, as seen in Indonesia where foreign firms who sell to the government have to take payment in Indonesian exports.

Although the evidence does show that East Asian markets are highly restrictive, there has been a recent trend in the region toward opening up to foreign competition. As mentioned before, while liberal trade has been the engine of growth in East Asia, the region has not been without its share of protectionist barriers. East Asia has begun serious multilateral negotiations to expand trade relations with the U.S. and remove import restrictions on several U.S. products. Mr. Brock, the U.S. trade representative, has warned the East Asian nations that protectionist pressures in the U.S. would increase this year. He has been trying to interest the NICs in negotiations with the industrial countries to liberalize trade barriers on all sides. Last year, the Korean government began a broad overhaul of its tariff rate structure; the government announced its target of having 95 percent of all goods fully liberalized by 1988. Indonesia, Malaysia, the Philippines, Singapore, and Thailand have agreed to a 25 percent across the board cut in present tariffs on items with import values of above $10 million as well as other measures to stimulate trade in the region.

The great benefits the U.S. has clearly gained from our booming commerce with East Asia is increasingly obscured by claims that Asian competition is destroying U.S. jobs and jeopardizing our economic future. Our huge trade deficit and the rapid penetration of lower cost Asian goods into our markets has made Asian nations a target of protectionism. Over the past few years, the East Asian countries, Korea and Taiwan in particular, have become formidable new rivals, not only in steel but also in autos, textiles, shipbuilding, machine tools, construction, and more recently, electronics – basic industries that were once the industrialized countries' domain. And, now the NICs have been trying to make the jump out of labor-intensive industries such as textiles, footwear, and simple electronic gadgets, into higher technology industries.

Yet, much of this Asian challenge is healthy: it provides low-priced, quality imports for U.S. consumers (which helps restrain domestic inflation), and markets for our exports. For example, since 1978, General Electric has doubled its trade with the region, with exports and imports totaling $2 billion in 1983. In addition, operating through joint ventures with local concerns, AT&T is going after a share of the $16 billion telecommunication industry in the region this year. American investment is also rising much faster in East Asia than in any other region. In the past five years, it jumped by nearly 65 percent, against a global rise of 39 percent. And at the end of 1984, U.S. direct investment in these countries stood at more than $30 billion.

In addition, the extraordinary economic growth of the region has spawned political stability and market-oriented approaches compatible with U.S. foreign policy goals. The high growth rates in East Asia portend even greater promise for U.S. exports and more jobs for U.S. workers. Indeed, 1.3 million jobs are related to U.S. exports to East Asia. Only with the preservation and expansion of an open trading system can the great benefits of East Asian trade continue, a trade now growing at about 20 percent annually.

Conclusion

Explaining the East Asian economic miracle has recently become a popular topic of discussion. Some attribute it to East Asia's inherited Confucian values; a respect for authority that creates stable politics; a willingness to save and work hard for the sake of children and posterity; or some vague undefined consensus between government and business. However, the real East Asian edge has to be that its prosperous nations have pursued economic policies that emphasize free markets and private enterprise. Developing countries tend to be short of capital, so the Asian nations sought foreign investment and treated it well. As a result, they had to borrow less and (apart from the special case of the Philippines) avoided the debt woes of Latin America. Their wages were low, so they aimed low-cost products at consumers in high-wage countries; now Asian-made products fill Western stores, and Asian exporters are some of the most competitive anywhere. And, in addition they keep their taxes low enough to give local entrepreneurs the incentive to grow. However, this is not to imply that every country in the region has embraced the market so closely or as successfully as for example, Taiwan and Singapore. In addition, the region's political development lags behind its economic progress. External threats (from Vietnam or the Soviet Union) or internal dissension (as in the Philippines) could suspend their economic progress.

The Korean language has a slang phrase for goodbye that Koreans use as much as Americans use the phrase, "take it easy." The Korean version, however, translates as "work hard." That seems an appropriate phrase for most of the East Asian countries in the next few years. They will probably have to work harder to achieve less remarkable results than before. High exposure to international trade makes the region more vulnerable than most countries to serious disturbances elsewhere in the world. But so long as the world continues to reward productivity and hard work, East Asia is likely to continue as a world center of prosperity and high economic performance.

TRENDS IN COMMERCE NOTES ON TABLE II

by
Martin Lefkowitz
March 1985

Gross National Product (GNP)—The Department of Commerce revised estimate for economic activity in the fourth quarter of 1984 indicates that GNP—the value of the nation's output of goods and services—grew at an inflation-adjusted 4.9 percent annual rate, a significant upward revision from the earlier estimate of 3.9 percent growth and almost double the increase of 2.8 percent reported in the December flash forecast. Business fixed investment was up 19.7 percent for all of 1984, the best performance in recent economic history. The revised data for the fourth quarter indicated a significant slow down in investment spending to 6.3 percent from 13.7 percent in the third quarter and over 20 percent in the first half of the year.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.8 percent in January. This resulted in a 10.6 percent increase (seasonally adjusted annual rate) in the money supply in the latest three month period. This performance places the nation's money supply up 5.9 percent from a year ago. The Federal Reserve's revised money supply data revealed that money supply growth in the fourth quarter did not slow down as much as the initial data had indicated. The revised data increased the annual rate of growth in the fourth quarter from two percent to 3.4 percent.

Employment—Civilian employment—as measured by the monthly survey of households—increased by 118,000 persons (seasonally adjusted), in January to 106.4 million, bringing the employment increase in the last twelve months to three million. The unemployment rate increased 0.2 percentage points in January following a 0.1 percentage point increase in December. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 350,000 in January. Three-fourths of the increase was in the service sector. The bulk of the increase in the goods producing sector was due to a rise in construction employment.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.2 percent in January, following a revised 0.3 percent increase in December. This reflects an across-the-board moderation in prices. Gasoline prices declined 1.4 percent in January and are now 15.2 percent below their March 1982 level, when prices were decontrolled. Food prices rose only 0.2 percent in March despite a 3.2 percent increase in fresh fruit and vegetable prices.

Wholesale prices of finished goods remained unchanged in January following a 0.2 percent increase in November. The January standstill in the price of finished goods can be attributed to a 2.4 percent decline in energy prices and a 0.6 percent decline in the price of consumer foods. The declines in energy and food prices were partially offset by increases in motor vehicles, food products machines, construction machinery and other capital equipment. Prices at the wholesale level have increased in two of the last six months, but they remain only 0.3 percent above their level of six months ago for this index. The wholesale price index for finished goods in January was 1.1 percent higher than its year-ago level.

The more volatile part of the Producer Price Index, crude goods, declined 2.2 percent in January. Crude material prices were an astounding 4.2 percent below their level of a year ago. Weak crude material prices appear to be a product of the strength of the dollar in international markets, which is driving down U.S. imports prices; and a glut of farm products, which is holding down crude food and feed product prices at the raw material level.

Housing Starts—Privately-owned housing units were started at an annual rate of 1,833,000 in January, 15 percent above the revised December rate of 1,595,000, but five percent below the number of starts a year ago. This gain was the result of an increase in apartment building construction. The seasonally adjusted annual rate in January for building starts with five or more units was 692,000, a 76 percent increase from the December rate of 393,000. The January rate of new starts for single family homes was 1,041,000, down four percent from December. Building permits issued in January were up two percent from December. This was the third consecutive rise in the number of permits issued, indicating that housing starts should continue to increase in the months ahead.

Industrial Production—Industrial production increased 0.4 percent in January following a 0.5 percent surge in December. This was the largest increase since July. Industrial output in January was 5.1 percent above the level recorded a year ago. Increases in production occurred in all major groupings of the index for the second consecutive month, with the strongest gains reported in automotive products, defense equipment and energy materials. Business equipment production rose 0.3 percent in January, following a 1.3 percent gain in December. This placed business equipment production at 12.1 percent above the level of a year ago, more than double the increase in production for the entire index.

The capacity utilization rate for manufacturing remained unchanged in January as factories operated at 82.1 percent of capacity, despite an increase in output in the manufacturing sector. Although this utilization rate is below the level of mid-1984, output has still increased because of a continued rise in available capacity and a high level of investment.

Business Costs and Productivity—The productivity numbers for 1984, released at the end of January, appear to give mixed signals. Total business productivity showed a gain of 3.6 percent, the largest single year gain since 1971. Manufacturing productivity rose by 4.7 percent last year, the best performance since 1973. For the fourth quarter of 1984, productivity was up 2.6 percent for all business and 1.7 percent for nonfarm business. However, the manufacturing sector registered relatively a large decline of 0.6 percent. This was the result of a decline of 1.6 percent in durable goods manufacturing productivity which offset a 0.9 percent rise in productivity in the nondurables sector. The decline in durable goods productivity came about as hours worked increased at a faster rate than output. However, this may be related to a data problem in the productivity numbers since the numbers for the fourth quarter of 1983 also indicated a decline in productivity following a very strong increase in the third quarter. In the fourth quarter of 1983, durable goods productivity declined 1.2 percent following a 10.2 percent increase in the third quarter. This is similar to the 1984 pattern which indicates a 1.6 percent decline following a 7.9 percent increase in the third quarter.

For the first time since 1971-72, the U.S. has enjoyed two consecutive years in which the productivity of the nonfarm business sector has increased by over three percent. What is most significant about these numbers is that this follows a period of five years (1977-1982) when the gain in nonfarm business productivity was nil.

It has been said that the current recovery in productivity is cyclical in nature, and that the recovery in productivity is similar to past recovery experience. The fact is that, in the first eight quarters of the current recovery, productivity in the nonfarm business sector grew by 6.2 percent. This is lower than the 7.3 percent increase in productivity for the same point in the recovery for the previous six recoveries which lasted as long. While the cyclical pattern is indeed true, and we tend to have greater increases in productivity in the initial phase of the recovery, we should not ignore one very important factor. Between 1948 and 1978, there were only two years when nonfarm business productivity did not increase, even in years when economic activity declined, productivity continued to rise. This string was broken in 1979 when we had a period of three out of four years (1979, 1980, 1982) with productivity declines. Further, for the five year period 1977-1982 there was no productivity change on a net basis. It is this reversal in the productivity trend that is one of the most significant aspects of the last two years.

Interest Rates—After a series of rapid declines that resulted in a hasty retreat from 13 percent in early October, the prime rate, now at 10.5 percent, has remained virtually unchanged for nearly two months. Both short- and long-term rates declined in January but are now back up to their December levels. Since last summer, when interest rates peaked, short-term rates have declined more than long-term rates. The federal funds rate, which was 11.47 percent in the week ending June 22, fell 303 basis points to 8.44 percent by February 15. At the same time, the AAA corporate bond rate declined from 13.71 percent at mid-year to 12.02 percent during the week of February 15.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicated that failures increased toward the end of January. The index of business failures, which uses October 1983 as a base of 100, reached 73.7 in the week ending January 25, over 26 percent below the October 1983 level. The number of business discontinuances remained close to the October 1983 level. The latest available data indicates that there were 481,569 new business incorporations in the first nine months of 1984, a 7.4 percent increase over the same nine month period in 1983. After increasing dramatically in the first half of the year, the level of new incorporations has stabilized at the same level as in the second half of 1983. At the current rate, new business incorporations in 1984 will have exceeded 640,000, a significant increase over the 600,400 new corporations of 1983, which was a record year.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, indicates that federal spending decreased one percent in January, but was still 12.9 percent above its year ago level. In the first four months of fiscal year 1985, federal expenditures increased 12.3 percent, about three times as fast as the increase in prices, indicating a real increase in federal spending of about eight percent from the year ago level. Only one-fifth of this increase is the result of rising defense spending. Receipts for January were up 12.9 percent from the same month a year ago due to large increases in personal income and social insurance taxes. Receipts for the first four months of the fiscal year are up 11.6 percent and are rising faster than income. The double-digit rise in federal outlays, despite rather modest inflation and a booming economy, indicates that the deficit problem is the result of uncontrolled federal outlays rather than inadequate tax revenues.

Personal Savings—According to Department of Commerce data, personal savings stood at six percent of after-tax income in the fourth quarter, nearly identical to the third quarter's figure. Personal savings in 1984 were nearly $40 billion higher than they were in 1983, with the percentage of income saved increasing from five percent in 1983 to 6.1 percent in 1984. This means that sixteen percent of the increase in personal income which occurred during 1984 found its way into savings.

Retail Sales—Retail sales advanced 0.7 percent in January, following a 0.5 percent decline in December. The December decrease was a direct result of declining gasoline prices and weaker automobile sales for the month. The traditional areas of Christmas shopping—department stores, clothing stores and restaurants—all experienced double-digit gains from last Christmas. The January data reflects a reversal of what happened in December: in January, retail stores showed weak sales, but this was offset by a strong automotive sector.

Trade Deficit—The trade deficit, on a goods and services basis, decreased from an annual rate of over $90.6 billion in the third quarter to $49.2 billion in the fourth quarter. This improvement is the result of a steep (the equivalent of nearly $38 billion at an annual rate) drop in merchandise imports, while merchandise exports actually went up slightly despite a continued strong advance in the value of the dollar. The largest decline in imports were in the capital goods area (17 percent); nonfuel industrial supplies also declined (11 percent); and automotive products were down by ten percent. The deteriorating U.S. international trade position is best exhibited by the fact that the deficit for goods and services, which was $62.5 billion in 1984, was only $8.3 billion in 1983, following surpluses in 1981 and 1982.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 1.7 percent in January, with eight of the 11 available indicators up. This follows a 0.5 percent decline in December. The January increase in the leading indicators series was the largest single month gain in this economic barometer since June 1983.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Dec/84	237.8	237.6	235.6	0.1	0.9
Gross National Product ($B) [a]	IV/84	3,764.2	3,694.6	3,431.7	1.9	9.7
Gross National Product (72$B) [a]	IV/84	1,664.8	1,645.2	1,572.7	1.2	5.9
Money Supply (M1) ($B) [a]	Jan/85	562.9	558.7	531.4	0.8	5.9
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Jan/85	2,429.9	2,416.4	2,288.8	0.6	6.2
Personal Consumption Expenditures (72$B) [a]	Dec/84	1,084.8	1,074.8	1,037.6	0.9	4.5
Disposable Personal Income ($B) [a]	Jan/85	2,671.7	2,657.0	2,482.2	0.6	7.6
Disposable Personal Income (72$) [a]	Dec/84	1,192.8	1,187.7	1,131.3	0.4	5.4
Personal Savings Rate (%)	Dec/84	6.0	6.3	5.2	-0.3[b]	0.8[b]
Civilian Employment (millions) [a]	Jan/85	106.4	106.3	103.3	0.1	3.0
Civilian Unemployment Rate (%) [a]	Jan/85	7.4	7.2	8.0	0.2[b]	-0.6[b]
Average Hourly Earnings [a]	Jan/85	$8.44	$8.47	$8.21	-0.4	2.8
Consumer Price Index (All Urban, 67 = 100)	Jan/85	316.1	315.5	305.1	0.2	3.6
Purchasing Power of the Dollar (1967 = $1.00)	Jan/85	0.316	0.316	0.327	-0.190	-3.411
Prime Interest Rate (%) February 28, 1985		10.5	10.5	11.0	0.0[b]	-0.5[b]
Retail Sales ($) [a]	Jan/85	110.7	109.9	106.6	0.7	3.8
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	IV/84	235.8	224.8	225.5	4.9	4.6
After Tax	IV/84	147.5	141.7	141.1	4.1	4.5
Industrial Production (67 = 100) [a]	Jan/85	166.6	165.9	158.5	0.4	5.1
Capacity Utilization Rate (Mfg.) (%)	Jan/85	82.1	82.1	80.1	0.0[b]	2.0[b]
New Housing Starts (thou. units) [a]	Jan/85	1,833.0	1,595.0	1,933.0	14.9	-5.2
Net Business Formation (67 = 100)	Jan/85	116.5	114.9	115.9	1.4	0.5
New Business Incorporations [a]	Sep/84	51,892	51,723	50,445	0.3	2.9
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100) [a]	IV/84	159.8	159.5	157.1	0.2	1.7
Unit Nonlabor Costs (77 = 100) [a]	IV/84	160.8	158.0	151.4	1.8	6.2
Producer Price Indices (67 = 100)						
Crude Materials [a]	Jan/85	322.2	329.3	336.2	-2.2	4.2
Intermediate Goods [a]	Jan/85	320.4	320.6	317.1	-0.1	1.0
Finished Goods [a]	Jan/85	292.4	292.5	289.2	0.0	1.1
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100) [a]	Jan/85	585.0	590.7	518.1	-1.0	12.9
Federal Government Debt Outstanding ($B)	Sep/84	1,576.7	1,565.1	1,381.9	0.7	14.1
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	IV/84	369.4	368.6	346.1	0.2	6.7
Imports of Goods & Services ($B) [a]	IV/84	418.5	459.3	375.9	-40.8[b]	42.6[b]
Balance on Goods & Services ($B) [a]	IV/84	-49.2	-90.6	-29.8	-45.9	64.8
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100)	Jan/85	166.7	163.9	164.5	1.7	1.3

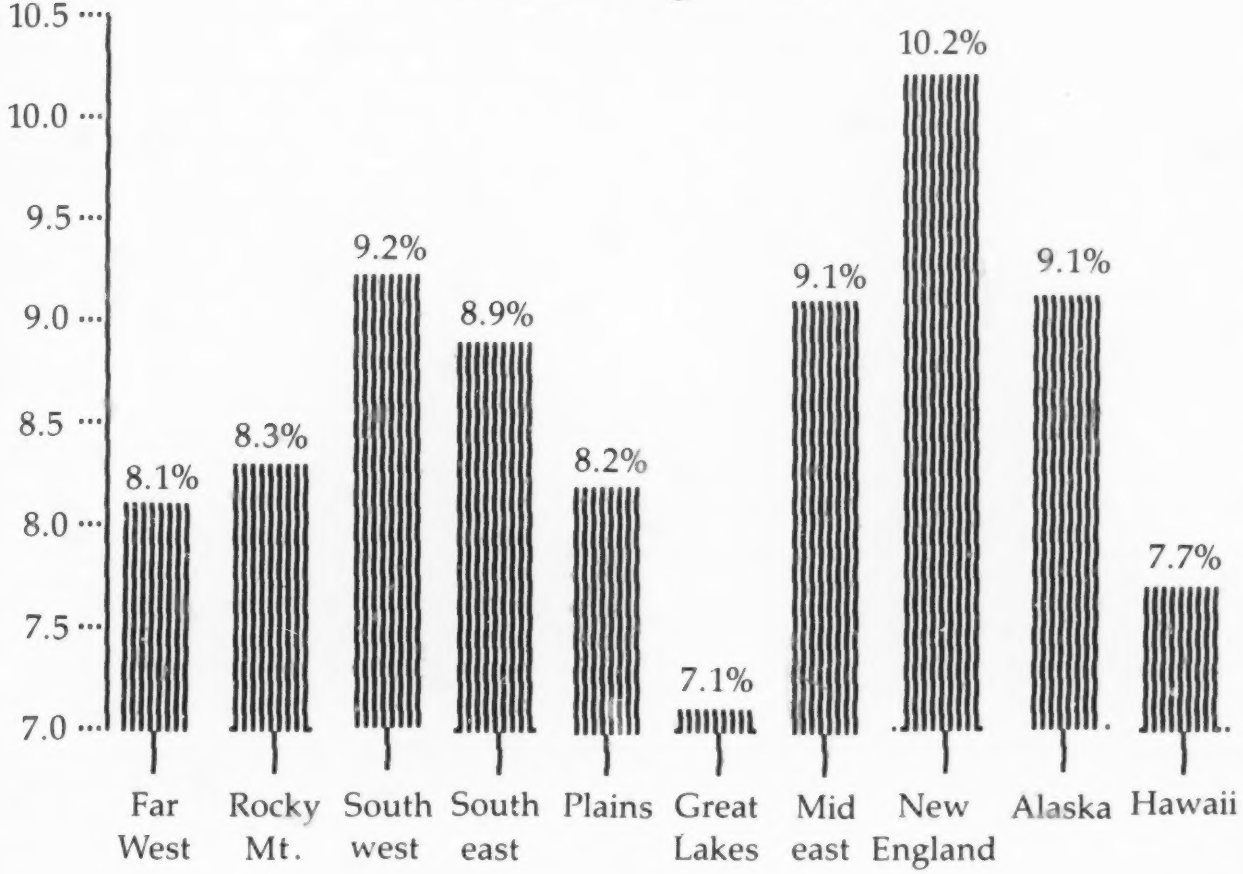
NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

GROWTH OF PER CAPITA PERSONAL INCOME
1978-83

Per capita personal income grew substantially during the past quarter century from an average of just over $2,000 in 1958 to $11,658 in 1983. While income levels differ from state to state, and the rate of income growth in the 50 states has also been uneven, certain trends have emerged. The most important is the convergence of incomes, signifying that prosperity in the U.S. is being shared more equally than it was in the past.

Twenty-five years ago, the Far West was the most prosperous region with an average per capita income ($2,436) that was two-thirds higher than the average lowest income region, the Southwest. In 1983, New England had the highest average income ($13,005) but the figure was less than one-third higher than the lowest placed Southwest. Another trend is that, on the whole, states with the lowest incomes had the fastest growth over the years. The reasons for this are varied. Industries are more likely to locate in states with lower labor costs, but there are a variety of other considerations, such as union strength and tax rates.

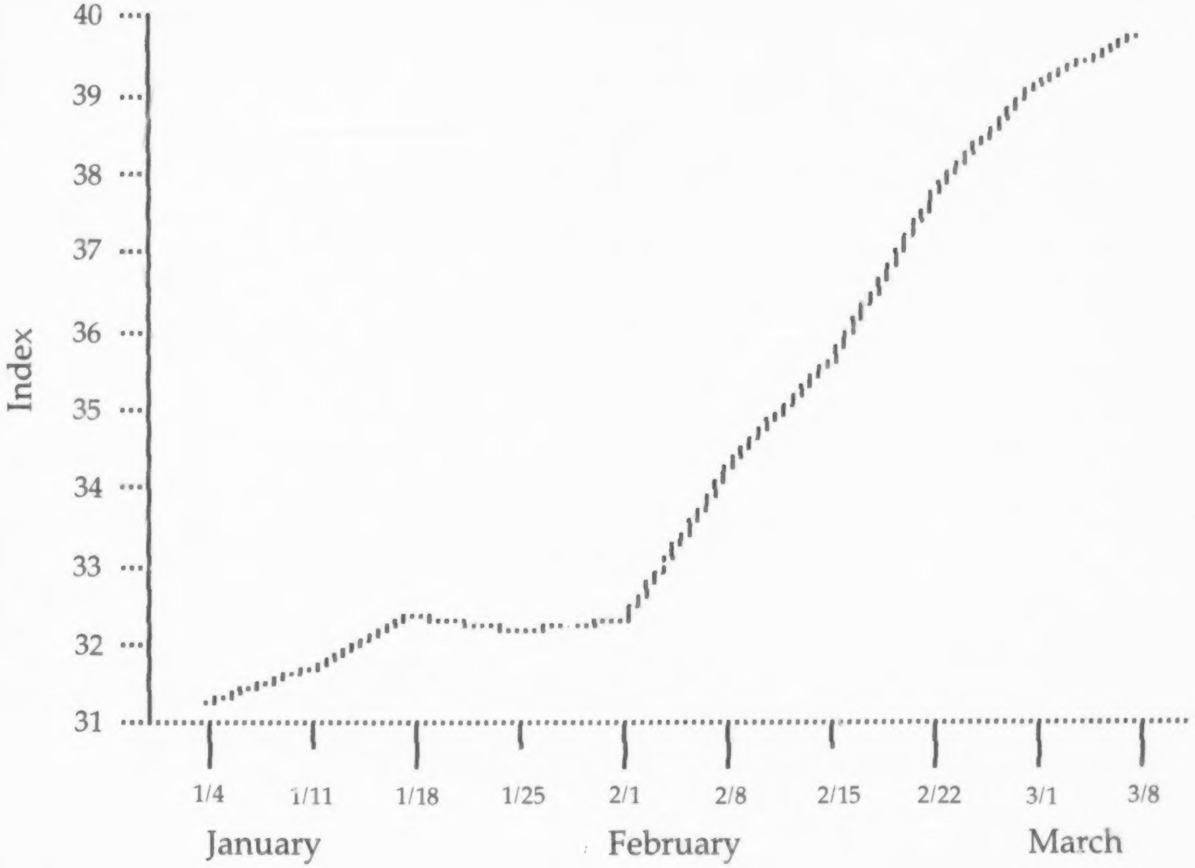
AVERAGE ANNUAL GROWTH RATE OF PER CAPITA PERSONAL INCOME
1978-83
National Average = 8.4%



INTERVENTION IN FOREIGN EXCHANGE MARKETS IS NOT A SOLUTION

In spite of day-to-day swings, the dollar's escalation, which began in early February, has not abated. The chart shows the dollar's trade-weighted average value for each week since the beginning of 1985. Intervention in foreign exchange markets by the Federal Reserve, the West German Bundesbank, and other European central banks, did nothing to stem the dollar's upward trend. It did, however, cost the central banks involved between $1 billion and $1.5 billion.

TRADE-WEIGHTED EXCHANGE VALUE OF THE U.S. DOLLAR



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ECONOMIC OUTLOOK

Chamber of Commerce of the United States
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DOMESTIC ECONOMY REMAINS BASICALLY SOUND DESPITE RISING THREAT FROM FOREIGN SECTOR

by Richard W. Rahn and Graciela Testa-Ortiz

Despite the unexpected weakness of the first quarter's preliminary estimate of total GNP growth, the domestic economy remains basically sound. Excluding the $73 billion decline in first quarter net exports, real GNP would have grown by 4.4 percent. The U.S. economy shows every sign of having settled into a healthy growth path.

Estimates for the first quarter show a strong consumer sector fueled by continued employment and income gains. While the civilian unemployment rate remained at 7.3 percent in February and March, this figure hides the continued ability of the U.S. private sector to create new jobs. Since mid-1984, even while the economy's growth slowed to a more sustainable pace, almost 2.2 million new jobs were created in the nonfarm sector. During the months of February and March alone, the economy created 493,000 new jobs. Furthermore, the percentage of the population at work in March rose to 60.3 percent, the highest rate in the nation's history.

During the year to February personal income rose 7.4 percent, fueling an 8.1 percent rise in consumer spending. Purchases of durable goods, and services remain strong, contributing to an impressive rise in February retail sales. Although March retail sales dropped 1.9 percent, this came on the heels of an unusually strong rise in February sales. Although the March data show a considerable decline in retail sales, they remain 5.8 percent higher than their year-ago level. Domestic automobile sales during the first quarter averaged 8.4 million units, and production plans for the second quarter remain optimistic. Sales of new single-family homes rose by 6.5 percent in February, a 15 percent increase from their August trough.

Business fixed investment has also experienced a respite, growing by only 8.5 percent in the fourth quarter of 1984, following five quarters of annual growth rates in the double digit range. But although the industrial production index fell in February, indications are that the lull may be over. The index of leading indicators rose for the third consecutive month, following several months of erratic movements. Presaging future increases in production and investment, orders for nondefense capital goods rose by almost 30 percent. Housing starts have remained above the 1.6 million unit mark since the beginning of the recovery, averaging 1.7 million units during the first three months of this year.

Buffeted by the combination of a strong dollar and weak foreign demand, U.S. merchandise exports fell sharply in February, contributing to an $11.5 billion merchandise trade deficit, even though imports also fell. Exports fell eight percent in February, the largest monthly decline in seven years, while imports declined by only 1.3 percent, primarily reflecting lower petroleum imports. Although the trade-weighted exchange value of the dollar has eased by about six percent in the past month, it is still more than two percent higher than it was last December. For further details regarding the dollar see the article, *The Mystery of the Dollar* in this issue.

The continual increase of protectionist pressures in the United States, particularly those geared towards Japan, raise the specter of an all-out trade war which threatens world trade. The trade deficit with Japan has widened significantly, now standing at $36.8 billion. The Reagan Administration continues to negotiate for easier access to Japanese markets, particularly in semiconductors and telecommunications. The U.S. and Japan are being drawn inexorably toward a protectionist showdown as Congress edges closer to converting verbal threats into retaliatory

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TABLE 1
UNITED STATES ECONOMIC OUTLOOK 1983-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS									YEARS		
	Actual		Forecast							Actual	Forecast	
	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	4.3	1.3	4.2	4.5	5.1	4.8	4.6	4.6	4.7	6.8	3.4	4.7
Consumption	3.6	4.7	3.9	4.0	4.0	4.1	3.7	3.6	4.0	5.3	3.9	3.9
Residential Investment	-5.9	-0.8	7.6	14.0	6.4	6.0	8.1	10.5	10.3	12.2	1.7	8.4
Business Fixed Investment	8.5	3.5	5.6	8.8	10.3	10.3	11.0	8.1	9.7	19.8	8.3	9.6
Equipment	5.4	-0.6	6.8	8.8	10.9	10.6	11.0	8.2	9.4	21.5	7.3	9.9
Structures	17.2	16.0	2.8	8.7	8.8	9.3	10.8	7.8	10.6	15.6	10.7	8.9
Exports	-0.8	-8.2	5.4	7.2	9.5	10.5	12.4	10.9	10.5	4.7	1.1	10.0
Imports	-28.3	26.1	11.1	4.6	8.1	6.9	6.4	5.2	6.2	27.0	8.7	6.7
Government Purchases	5.9	0.2	5.0	3.8	2.6	2.3	1.8	1.6	2.0	3.5	4.5	2.5
Inventory Change ($B)	36.6	46.6	51.7	46.4	51.0	51.6	48.9	49.5	47.7	58.2	48.9	49.4
New Car Sales (mil. units)	10.2	10.8	10.9	11.2	11.2	11.3	11.3	11.5	11.5	10.4	11.0	11.4
Housing Starts (mil. units)	1.6	1.7	1.8	1.8	1.9	1.9	2.0	2.0	2.1	1.8	1.8	2.0
EMPLOYMENT, WAGES AND PRICES												
Unemployment Rate (%)	7.2	7.3	7.3	7.2	7.1	7.0	6.9	6.8	6.7	7.5	7.2	6.9
Compensation	3.6	6.2	4.3	4.4	5.3	6.6	5.9	6.2	6.8	4.2	4.6	5.8
Productivity	2.7	1.8	3.0	2.5	2.4	1.7	1.4	1.8	2.3	2.8	2.2	2.0
Unit Labor Costs	0.8	4.3	1.3	1.9	2.8	4.8	4.5	4.3	4.4	1.4	2.4	3.7
Consumer Prices	3.5	3.1	2.6	2.9	3.4	4.0	4.0	4.0	4.2	4.3	3.2	3.7
GNP Deflator	2.8	5.0	1.6	2.0	2.5	3.3	4.0	4.3	5.0	3.8	3.2	3.3
Prime Interest Rate (%)	11.8	10.5	10.4	9.8	9.3	9.2	8.7	8.5	8.1	12.0	10.0	8.6
Profits from Current Production ($B)*	203.9	14.6	223.5	223.0	224.1	221.4	224.1	227.0	229.4	196.2	221.3	225.5
GOVERNMENT FISCAL POLICY ($BILLION)**												
Unified Budget–Receipts										666	736	983
Unified Budget–Outlays										842	949	798
Unified Budget–Federal Surplus or Deficit										-175	-213	-185

*Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government outlays of $40 billion in calendar year 1986. The money supply as measured by M(1), is expected to grow by 6.7 percent in 1985 and 7.2 percent in 1986. The marker price for OPEC oil is anticipated to fall to $26 per barrel in 1986. The federal minimum wage remains at $3.35 an hour throughout the forecast interval. The trade-weighted exchange value of the dollar is expected to rise by three percent this year before declining by 5.6 percent in 1986.

legislation. U.S. exporters are increasingly hampered by the strong dollar, sluggish growth in our trading partners' economies and import barriers–especially in Japan. However, the implementation of protectionist actions may serve to incite retaliatory measures from our trading partners, which will severly limit our export performance. The threat of foreign retaliation is a real possibility, in fact, the European Parliament has already passed a resolution calling for just such action should the U.S. enact an import surcharge. Unfortunately most of the protectionist actions being proposed will cause far more pain to the U.S. consumer, and ultimately to U.S. economic growth than to our trading partners. Such masochistic measures need to be firmly resisted.

As the economy's expansion continues to settle, the public policy risks become more onerous. While the absence of tax increases in the White House/GOP Leadership compromise package of deficit reductions is a good omen, the risk of higher taxes is not altogether over. In fact, fears of a watering down of ACRS and the elimination of the investment tax credit under a compromise tax reform package, may improve the near-term investment outlook as firms accelerate their spending plans to take advantage of tax incentives which may disappear. However, this development may bode ill for investment spending in 1986 and beyond since it would significantly raise the cost of capital and lower business investment and productivity. For further information on these issues, see *The Productivity Challenge* and *Capital Cost Recovery and Tax Reform* in this issue.

In sum, given the first quarter weakness of real GNP growth, our forecast shows weaker growth rates for 1985 and 1986, on a year-over-year basis. Nevertheless, the quarterly growth rates are anticipated to remain close to five percent, a very healthy rate for the third year of an economic expansion.

THE PRODUCTIVITY CHALLENGE

by Graciela Testa-Ortiz

Growth in productivity, that is, the efficiency with which inputs of labor, capital, energy, and materials, are used in the production process, is the key to long-run economic health and a rising standard of living. Simply put, the more we produce, the more we have to consume and invest.

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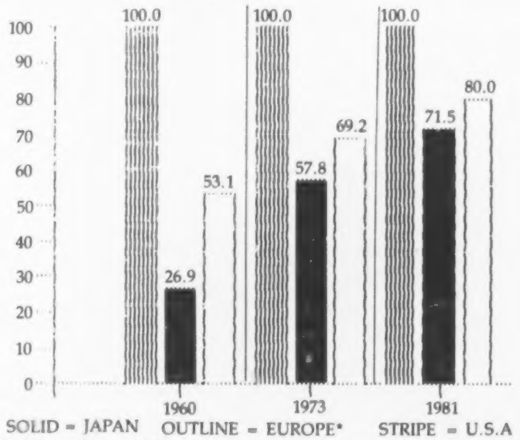
This suggests a challenge to our nation's policy makers. The data show that the major impact on recent productivity trends has been the result of the 1980s reversal in public policy choices which placed an emphasis on economic stability, increased incentives to save, work and invest, and the move towards deregulation of certain key industries. The challenge before us now is to ensure that the long-run health of the U.S. economy remains a prime consideration. Further improvements in productivity, and indeed, the reversal of the 1970s trend, are predicated upon the continuation of these policies.

A 1984 study by Harris Trust and Savings Bank of Chicago concludes that under present legislation, effective marginal tax rates could rise by 2.8 percentage points between now and the end of the decade. The effect of this increase in tax rates on productivity would be to negate recent improvements and return the economy to the lackluster performance of the 1970s. According to their study, by the end of the decade the economy would be producing $180 billion fewer goods and services–the equivalent of $3,000 per American family–than would be the case if the present productivity trend were to continue. In addition, most of the tax reform proposals now under consideration would increase the cost of capital (see *Capital Cost Recovery and Tax Reform*, in this issue), further dampening capital investment, productivity, and the outlook for overall economic activity.

The urgency of facing up to this challenge becomes even more important when we note that in spite of the improvement recently experienced, differences of opinion exist as to whether this increase in productivity represents a turnaround in the downward trend which began in 1973, or if it is only a cyclical phenomenon. Furthermore, the latest data show that while the upturn in productivity during the recovery was significant, the rise in both nonfarm business and manufacturing sector productivity remains below the average for similar periods during

CHART 1
GROSS DOMESTIC PRODUCT
PER EMPLOYED PERSON
(percent)



*Includes France, West Germany, Italy and the United Kingdom.

the past four recessions (excluding the 1958 and 1980 recoveries which did not last as long as the current episode). Also, while the U.S. productivity level remains above that of our major trading partners, chart 1 shows that these nations are rapidly catching up with the U.S. level.

WHY IS STRONG PRODUCTIVITY GROWTH IMPORTANT?

Increases in output per unit of input affect the economy in ways other than just raising efficiency and allowing for increased production with a given level of resources. Inasmuch as productivity increases are the major source of improvements in the hourly compensation of employees, they allow for increases in the standard of living of a country's residents.

Productivity also has an impact on inflation. Any increase in nominal wages beyond that justified by improved labor productivity results in rising costs and increased price pressures. By reducing unit labor costs, productivity improvements curtail increases in inflation.

Further, a strong rate of growth in productivity enhances the economy's international competitiveness, because highly productive economies can offer their goods and services in the international marketplace at relatively lower prices than their less productive competitors. Consequently, strong productivity growth buoys exports and GNP.

TRENDS IN PRODUCTIVITY PERFORMANCE

During the 1970s, U.S. productivity performance slowed dramatically. Productivity in the private business sector slipped from a 3.4 percent average annual rate of growth in the 1960s, to 1.7 percent during the 1970s. Looking at the period prior to 1973, when the 1970s slowdown became evident, shows that between 1948 and 1973, output per hour rose at an average annual rate of 3.7 percent, but the increase slipped to only 2.2 percent per year between 1973 and 1981. Another way of examining the productivity slowdown is to remove cyclical movements in the index by comparing periods with similar rates of capacity utilization. This shows that between 1954 and 1972 the productivity trend averaged a rate of growth close to two percent, but that it fell to only 0.9 percent between 1972 and 1978, and 0.2 percent between 1977 and 1981.

The 1970s slowdown in productivity growth was not isolated but represented a worldwide phenomenon. Growth in manufacturing sector productivity fell by 0.5 percentage points in the U.S. during the 1970s compared to the 1960s. It fell by 6.3 percentage points in Japan, and an average of 2.5 percentage points in France, West Germany, Italy and the United Kingdom. During the first three years of this decade, U.S. productivity performance increased slightly relative to the experience of the 1970s, while productivity in Japan, Canada, France, Italy, and West Germany continued to slide (see table 1).

The explanation for this slowdown in output per hour can be found by studying the 1970s performance of the factors that determine productivity growth. Productivity is affected by a host of interrelated factors. These include the demographic characteristics of the working population; the rate of capital formation and the quality of the capital stock; shifts in the economy's industrial composition; the amount of resources devoted to research and development; inflation; energy shocks; government regulation and tax policy; capacity utilization; and even the attitudes of workers and managers towards productivity.

TABLE 1

GROWTH IN MANUFACTURING PRODUCTIVITY

(average annual percent change)

	1950-59	1960-69	1970-79	1980-83	1982	1983
U.S.	2.3	3.6	3.1	3.2	2.1	4.2
Canada	4.5	5.6	4.0	1.9	-2.8	6.4
Japan	12.5	16.4	10.1	6.6	8.2	5.0
France	5.6	9.0	6.6	4.9	5.5	5.9
W. Germany	9.8	8.1	5.7	2.6	1.2	4.7
Italy	7.2	10.0	5.8	2.7	2.8	1.6
U.K.	1.9	4.6	3.5	5.8	3.9	6.6

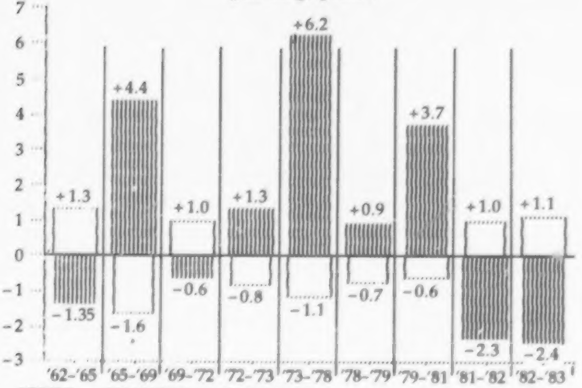
Source: Bureau of Labor Statistics
December 1984

Explaining the Slowdown: Government Policy

Of this long list of determining factors, some, such as demographics and the energy shocks of the 1970s, are beyond public policy influence. However, those factors that can be influenced by public policy are the most important ones, not only because they are amenable to change, but also because they can be shown to have an impact on the remaining factors. For instance, we have listed educational attainment, savings and investment as important variables determining productivity. However, policy decisions can and do affect these variables. What motivates people to work, save, invest and improve their productive efficiency? Part of the answer lies in the marginal tax rates associated with an economy's revenue system. Higher taxes have an immediate adverse effect on productive work, savings and investment. Wage and salary workers, as well as entrepreneurs, may find it more attractive to substitute leisure for work, or avoid new ventures, as additional earnings and profits are taxed at higher rates. High tax rates, therefore, result in an inefficient allocation of resources.

In support of this, studies have found that changes in structural productivity, that is, productivity adjusted for the impact of business cycles, coincide with changes in tax rates: during periods in which tax rates have risen, productivity has fallen. Evidence suggests that, since the 1950s, a one percentage point change in effective marginal tax rates has been associated with a 0.33 percentage point

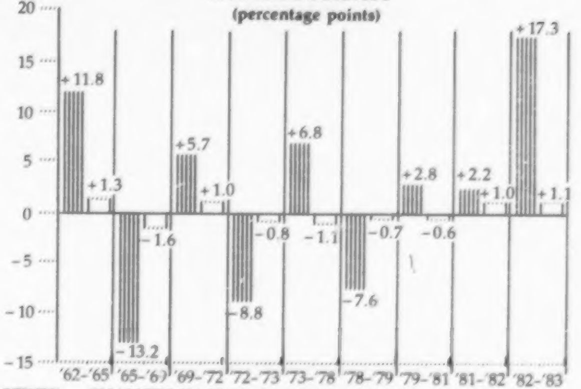
CHART 2
CHANGES IN TAX RATES(a)
AND PRODUCTIVITY(b)
(percentage points)



STRIPE = CHANGES IN TAX RATES
OUTLINE = CHANGES IN PRODUCTIVITY
(a) Tax changes are differences in effective marginal rates.
(b) Productivity changes are differences in structural trends.

Source: Robert Genetski, "The Impact of Marginal Tax Rates on Productivity Performance," testimony submitted to the Congressional Subcommittee on Oversight of the IRS, April 13, 1984.

CHART 3
CHANGES IN BUSINESS INVESTMENT(a)
AND PRODUCTIVITY(b)
(percentage points)



STRIPE = CHANGES IN BUSINESS INVESTMENT
OUTLINE = CHANGES IN PRODUCTIVITY
(a) Changes in business investment are percentage point differences between the average annual growth rates in real nonresidential fixed investment with a one period lead.
(b) Productivity changes are differences in structural rates.

Source: U.S. Chamber of Commerce, Forecast Center and Robert Genetski, *ibid.*

change in productivity in the opposite direction. Chart 2 shows the importance of changes in effective marginal tax rates on productivity quite dramatically.

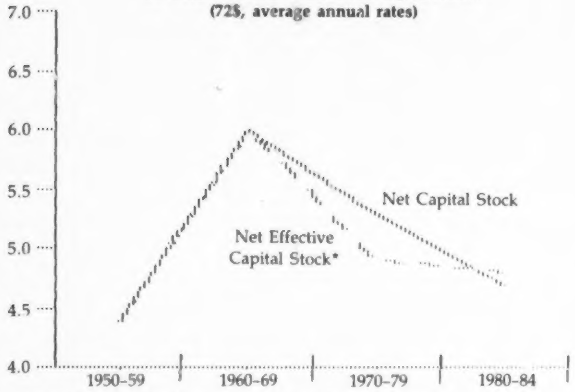
The productivity crisis during the 1970s began with the first oil price shock of 1973 and was compounded by a series of negative policy decisions which exacerbated the impact of the variables beyond policy influence. As an excessively accommodative monetary policy corresponded with the rise in energy costs, inflationary pressures spiraled. When combined with tax and regulatory impediments, this reduced the rate of growth in business investment, in turn, contributing to the deterioration of worker productivity that occurred after 1973.

Increases in capital investment enhance productivity by making more and better tools available to workers. Mechanizing a production process results in a higher level of output per worker. Chart 3 shows the relationship between changes in business fixed investment and changes in nonfarm productivity. Note that the time periods chosen coincide with those in chart 2, that is, they are representative of periods which witnessed reductions in marginal tax rates. Charts 2 and 3, therefore, make clearly evident the link between marginal tax rates, capital investment and productivity performance. The only exceptions are the years between 1973 and 1978, and 1979 and 1981 when business investment rose, but productivity fell. This aberration may be explained by the massive rise in regulatory requirements. Between 1973 and 1981 capital expenditures for pollution abatement rose at an average annual rate of over 20 percent, thereby diminishing the investment in productivity-enhancing equipment.

Periods of rapidly growing inflation coincide with low productivity growth, although the relationship is far from coincidental. An inflationary environment, combined with a tax system which does not take inflation into account, seriously depresses productive investment. This was exactly the situation before the enactment of the Accelerated Cost Recovery System (ACRS). During the 1970s, depreciation allowances were based on historical cost and were, as a consequence, inadequate to compensate for the increase in replacement costs which resulted from rapidly rising prices. Inflation raised the tax burden on businesses as well as the cost of capital, curtailing the growth of investment in productivity-enhancing plant and equipment. Further, before the enactment of income tax indexation, inflation-induced bracket creep raised marginal tax rates on individuals, reducing incentives to save, work and invest. And, the tax deductibility of interest payments, by encouraging the use of consumer credit, further restricted the pool of savings available for investment.

The 1970s was also a decade of rapid growth in government regulation. Regulations for pollution, health and, safety compounded the effect of inflation and tax impediments on productivity. In order to comply with these regulations, firms had to channel their investment spending away from updating their plant and equipment, and towards meeting these new standards. Even though these expenditures yielded an intangible benefit in the form of a cleaner environment and a potentially safer workplace, they did nothing to improve or expand productive capacity. Indeed, between 1972 and 1980, expenditures for pollution abatement and control rose by 200 percent—an average annual rate of 25 percent—while nonfarm labor productivity rose by only 0.7 percent per year. As chart 4 shows, the nation's net capital stock grew at a slower rate in the 1970s than it did in the 1960s. Further, the net capital stock adjusted for expenditures such as pollution abatement, rose at a slower rate that the unadjusted series.

CHART 4
GROWTH IN THE NET CAPITAL STOCK
OF PRODUCERS' DURABLE EQUIPMENT
(72$, average annual rates)



*Adjusted for expenditures such as pollution abatement.

Explaining the Slowdown: Other Determining Factors

Public and private investment in research and development, by paving the way for the development and introduction of innovations and new technologies, also plays a significant role in enhancing productivity. Although the link between R&D spending and technological improvements in the production process is difficult to quantify, studies show that the direct returns to R&D spending are approximately 20 percent. During the past decade, public and private R&D spending accounted for 1.6 percent of GNP, compared to two percent between 1963 and 1969.

Demographic factors also affect worker productivity. Important among these is the age structure of the working population. Productivity is enhanced if the fastest growing segment of the labor force is in the 25 to 54 age group, that is, representative of more experienced workers. Alternatively, when the proportion of the 16 to 24 year old population is growing more rapidly, productivity tends to decrease as these workers have little work experience and low skill levels. The sex composition of the labor force is also important. A large influx of women into the labor pool may depress productivity because, by and large, women have tended to have less work experience than men of the same age group due to their later entry into the work force. The level of educational attainment of the population also has a bearing on labor productivity. Increases in the proportion of the work force with four or more years of college education have been shown to have an important impact on productivity.

During the 1970s, the labor force grew at a 2.6 percent rate, with the bulk of new entrants being the baby boom generation and women, each entering the job market with limited skills and experience. Between 1948 and 1981, the proportion of the work force in the 16 to 24 age bracket rose from 19.5 percent to 23 percent. At the same time, the proportion of women in the labor force rose from 29 percent to 43 percent. This combination lowered the average level of experience of the labor force. The educational level of the work force, on the other hand, improved significantly, mitigating some of the negative effects of the age-sex composition.

Any shift in the composition of output away from low productivity sectors enhances productivity. The movement from farm sector employment to the nonfarm business sector raised productivity between 1948 and 1973. During the past two decades, the shift in output and employment from manufacturing to the services sectors has become more apparent and led some to believe that it has depressed productivity growth. However, the data do not support this perception; in fact, they point to a positive impact on total factor productivity.

The misconception has arisen from the widespread reliance on the one-dimensional measure of labor productivity, rather than total factor productivity, as a measure of economic efficiency. However, labor productivity does not take into account other factor inputs, or changes in their mix. The increase in productivity in the service sector, in both absolute and relative terms, has come about as a result of the contribution of capital rather than labor, the increased use of computers – the emerging paperless office and CAD/CAM processes – being prime examples. To be sure, some industries within the service sector, such as in the business and personal services categories, do have a low productivity performance. However, these represent a small percentage of the total service sector.

RECENT EXPERIENCE

So far this decade, the U.S. economy has experienced a substantial turnaround in productivity performance. Since the end of the recent recession, nonfarm business sector productivity rose by 6.7 percent, while manufacturing productivity increased by 7.6 percent.

To be sure, factors beyond the control of government policy have enjoyed a significant improvement during the 1980s. The age-sex composition of the U.S. labor force has now become an enhancing rather than retarding factor as the baby boom generation moves into the more productive age groups. The young, inexperienced workers of the 1970s are becoming the mature, experienced workers of the 1980s. Furthermore, the likelihood of a repetition of the energy price shocks of the 1970s is virtually nil. If anything, world oil prices are expected to remain soft throughout the rest of the decade (see *World Oil Markets: What Now?*, ECONOMIC OUTLOOK, May, 1984).

However, the most significant factor contributing to the improvement in the outlook for productivity stems from the positive policy developments instituted during the first Reagan Administration. The Keynesian adage that "in the long run, we are all dead," contributed to the short-sighted management of economic policy. Now, the long run has regained its importance.

Policies instituted since 1980 have been explicit in their concern for the economy's long-term health, and their impact is readily apparent. The emphasis on deregulation, lower tax burdens, capital formation and economic stability has already yielded results. Expenditures for research and development have rebounded, reaching about 2.7 percent of GNP, close to its 1968 peak. Further, the impact of increased R&D spending on productivity is likely to be larger during the 1980s than it was during the past decade, when companies found it necessary to spend large amounts of funds to offset rising energy costs and comply with new regulatory requirements.

The Economic Recovery Tax Act of 1981 (ERTA), and in particular, its provisions for accelerated depreciation and indexation of personal income tax rates, has reversed the pattern of rising tax burdens which thwarted business investment in the past. As a result, not only has this recovery witnessed the largest rise in business fixed investment of any post-war recovery, but the ratio of business investment to GNP has averaged 11.5 percent during the last five years, and reached a record of 12.5 percent during the last quarter of 1984, compared to 10.7 percent in 1970-79 and ten percent in 1960-69.

The Harris Trust study mentioned above, concludes that the bulk of the improvement in cyclically-adjusted productivity between the third quarter of 1981 and the end of 1983 is attributable to the enactment of the Economic Recovery Tax Act of 1981. Chart 2 above, shows the improvement in cyclically-adjusted productivity which followed the ERTA reduction in effective marginal tax rates.

CONCLUSION

The implication is that "leaving well enough alone," will not be sufficient to maintain the levels of productivity recently achieved—further progress is imperative. What this country needs, then, is a commitment to those policies which have already proven their efficacy. The move towards deregulation, a major component of the policies of the first Reagan Administration, has recently waned (see *Lightening the Load of Regulation*, ECONOMIC OUTLOOK, December 1984). A recommitment to this ideal is paramount to the achievement of further increases in productive investment. Privatization of government services, a goal which has received some lip-service, should be aggressively pursued. A shift in output and employment away from the relatively less productive public sector will enhance economy-wide efficiency (see *Privatization of Government Services: Improved Efficiency at Lower Cost*, ECONOMIC OUTLOOK, December 1984). Noninflationary monetary policy, which has been remarkably successful thus far, should remain a prime public policy aim. Finally, since current tax legislation implies a gradual increase in effective marginal rates, a reversal of this trend is clearly necessary if we are to solidify the productivity gains recently achieved.

THE MYSTERY OF THE DOLLAR

by R. Bonnie Ohri

Few propositions are so often stated with as much confidence by economists and commentators as the following: First, the dollar is "overvalued"; second, the strong dollar harms our economy while a weaker dollar would reap more benefits for exporters; third, the strong dollar is responsible for the increase in the trade deficit; and finally, official intervention in the foreign exchange markets will lower the value of the dollar. The confidence with which these propositions are being stated derives not from experience and analysis, but from the belief that they are intuitively obvious and from their endless repetition by the media.

But, as this article demonstrates, the validity of these propositions is limited. The purpose of this article is to carefully consider these views so that attempts to solve the dollar dilemma do not inflict serious damage on the U.S. economy.

Is the Dollar Overvalued?

For some time, certain public and private sector policymakers, businessmen, and academics have held the view that the value of the dollar is too high in relation to the currencies of our major trading partners. Between late 1980 and 1984, strong demand for the dollar pushed up its value by 40 percent against the British pound, 50 percent against the German mark, over 100 percent against the French franc, and 15 percent against the Japanese yen. Yet, there is no operative standard by which to judge whether, and by how much, the dollar is overvalued. The dollar is, generally speaking, responding to market forces. Although the idea of an overvalued dollar is rapidly becoming part of today's conventional wisdom, it is very difficult to define and even more difficult to defend.

Just what does it mean to say that the dollar is "overvalued"? In the years before 1973, when exchange rates were fixed by government intervention, the notion of an overvalued currency meant the dollar was overvalued if permitting it to float freely would cause its value to fall relative to other currencies. In other words, the exchange rate in a free market was the standard by which to judge whether an historically fixed exchange rate was currently overvalued or undervalued. Such an interpretation is no longer applicable. The dollar now floats freely relative to other currencies and its value reflects the consensus assessment by the world's financial markets through the interaction of supply and demand for the dollar. By the traditional standard, it is meaningless to say that the dollar is overvalued as it is to say that apples or typewriters are overvalued.

It is worth noting that the recent surge in the dollar's value can be viewed as doing nothing more than restoring the exchange rates that characterized world trade until the decade of the 1970s, when a succession of bad economic policies and the consequent deterioration of our economy led to a collapse of the dollar's value. Indeed, despite its recent surge, the dollar has barely regained the ground that it lost *vis-a-vis* the West German mark during the 1970s. When the exchange rate of the dollar is stated in terms of special drawing rights (SDRs), a weighted group of currencies used by the International Monetary Fund as a financial benchmark, the dollar in 1984 merely equals its 1970 strength. However, during that period, individual currencies such as the British pound, Italian lira, and French franc have varied more dramatically against the dollar, while other currencies such as the German mark and Swiss franc have seen a smaller degree of variation (see table 1).

TABLE 1
FOREIGN CURRENCIES PER U.S. DOLLAR

Currency	1970	1980	Average of February 11-15, 1985
German mark	3.65	1.82	3.28
French franc	5.53	4.22	10.03
British pound	2.40	2.33	1.10
Italian lire	627	856	2021
Japanese yen	358	227	260
Swiss franc	4.3	1.68	2.5

Why is the Dollar Strong?

Since 1980, the trade-weighted value of the dollar has risen by between 40 to 70 percent, depending on one's precise base and weighting method. There are many who believe that high U.S. interest rates relative to those prevailing abroad, are responsible for the large demand for dollar-denominated assets. Recent evidence, however, disproves this conclusion.

The dollar has remained strong even as U.S. interest rates fell and foreign interest rates rose. Between early September and mid-March, the 3-month Eurodollar rate fell by 275 basis points. By way of comparison, the Canadian Eurodollar rate fell by just 87 basis points, the Eurofranc rate eased by 22 basis points, and the Eurolira rate declined by 50 basis points. All other major Eurocurrency rates actually rose, with the Euromark rate rising 81 basis points and the Eurosterling rate rising by 275 basis points. Adjusting the Eurocurrency rates for changes in inflation yields the same results in terms of likely pressures on the dollar. The decline in the real Eurodollar rate during this period was 45 basis points. Yet, the real Eurosterling rate rose by 535 basis points, and the real Eurofranc rate rose by 158 basis points. However, during this period, far from easing, the trade-weighted exchange value of the dollar rose by 11.6 percent.

What explains this apparently perverse movement in the dollar exchange rate? There are a number of reasons for the strength of the dollar, the primary one being the remarkable performance of the U.S. economy. Lower tax rates, deregulation, and noninflationary monetary policy have produced strong gains in the potential real growth of the U.S. economy. The recovery in the U.S. has been solid and has moved rapidly into expansion, while inflation has dipped dramatically – at four percent, it is at its lowest since 1967. Unemployment has declined, with the U.S. economy creating over seven million new jobs since 1980. Second, the U.S. is perceived as a safe haven in a troubled world. Third, the relatively weaker economic performance among the European nations has further enhanced the perception of U.S. economic vitality. The economies of Europe are hobbled by closed markets, rigid labor systems and high taxes. Fritz Leutwiler of the Swiss National Bank states that, "The U.S. is seen by investors as young, flexible and dynamic and Europe old, schlerotic, and much less flexible." The respective strengths of the economies and currencies of the U.S. and Europe reflect, in large part, the wisdom or folly of their respective domestic economic policies. Fourth, the demand by foreign debtor countries for dollars to help service their large dollar-denominated debts has caused these countries to move from non-dollar to dollar assets. And fifth, the unique role of the dollar in the international monetary and trading system has added to its strength.

The Strong Dollar: A Problem?

Although competition from imports helps keep down the prices of domestically produced goods, several U.S. industries have been adversely affected by the dollar's strength. The strong dollar makes it difficult for certain U.S. industries, such as steel and textiles, to compete with foreign goods. Many other export-oriented industries also suffer. On the other hand, these industries, in order to effectively compete with imports, have been forced to seek more efficient production methods and drastically reduce costs. In the case of exporting firms, such action has made production leaner and more innovative, laying the foundation for a more efficient export sector. In addition, those industries purchasing imported raw materials or capital goods do so at a bargain, thanks to the dollar's strength

Popular wisdom has it that the strong dollar is the primary culprit for the flood of foreign manufactured goods into the U.S. But using the dollar as a whipping boy for the import wave ignores the important deep-seated structural changes behind this surge. To be sure, the strong dollar has only exacerbated the problem faced by U.S. exporters. Other important factors hurting them are: relatively high costs of production – both labor and capital – in the U.S. place American manufacturers at a competitive disadvantage *vis-a-vis* lower cost producers such as Korea and Japan; and until recently, U.S. manufacturers have generally ignored foreign markets.

Clearly, the strong dollar allows Americans to purchase foreign goods more easily and at lower relative costs than if the dollar were weak. But far from harming the U.S. economy, this helps it by keeping our inflation rate down. The general rule of thumb is that a ten percent change in the value of the dollar causes a 1 to 1.5 percentage point change in the overall rate of inflation. Based on this rule, the strength in the dollar since 1980 has reduced domestic inflation by almost two points per year. Foreign competition has also increased competition in U.S. labor markets, maintaining downward pressures on wages, and further restraining inflation. Wage increases last year were the lowest in 17 years.

The broad lesson here is that, compared with most, our economy is still self-contained. But our obsession with foreign threats blind us to this basic reality. Just because more industries face foreign competition does not mean our economy has completely fallen hostage to international influences. And just because U.S. companies can shop around the world for parts does not mean that American manufacturing is being obliterated. The mistake is to generalize the experiences of individual firms and industries to the economy as a whole. In the process, we overlook the immense advantages of the American economy. As the world's largest market, the U.S. is a perpetual cauldron for new products and applications. Having such a huge and diversified home market is a strength that no other nation can match.

Would a Weaker Dollar Help?

Although a weaker dollar would certainly help exporters and diminish the trade deficit, the process would take at least two years to occur since trade adjustments tend to lag changes in exchange rates. The initial impact on the trade balance may well be negative as price effects offset volume effects. This is likely to occur because price and volume adjustments to a change in the dollar's value will not come about instantaneously, but may, in fact, take several quarters. There is also a delay for the volume of exports and imports to adjust to price changes due to the costs involved in shifting sources of supply. For instance, a decline in the dollar's value may open up new markets for U.S. producers, but it will take time for them to acquire the capacity necessary to increase production.

It is far from certain, moreover, that a weaker dollar would aid U.S. exporters in the long-run. Recent history indicates that the balance of trade does not significantly improve or deteriorate in relation to the value of the currency. From 1976 to 1978, despite the plummeting dollar, the U.S. trade gap widened: It jumped from $17 billion to $40 billion during that period, and from then until 1982 remained in the range of $36 billion to $42 billion while the dollar lost 31 percent in value to the yen, 21 percent to the mark, and six percent to the pound and the franc.

Agricultural exports, a vital component of U.S. trade, would remain largely unaffected by a weaker dollar. Those exports, more than $38 billion in 1984, respond to world market incentives; their U.S. dollar price fluctuates sometimes as much as 50 percent in a year in response to temporary imbalances between available supplies from a few producing countries, including the U.S., and demand from a relatively small number of large importers. In fact, when grains or soybeans prices surge, the amount of money needed to pay for their importation escalates, bringing upward pressure on the rate of exchange. The dollar reacts to the international trade of those commodities rather than the other way around.

Thus, a weaker dollar might help particular export firms in the long run, but it is questionable whether the U.S. export sector as a whole would gain. The nature of foreign demand would determine the change in export income for each company, while some effects of a weaker dollar would affect exporters adversely.

Strong Dollar, Trade Deficit Link?

In 1984, the U.S. merchandise trade deficit rose to $107.4 billion (on a balance of payments basis)—an increase of 76 percent, in constant prices, over 1983. According to conventional wisdom, the dollar's appreciation is the cause of the increased deficit because the overvaluation, like a tax on exports, raises the prices charged in foreign currencies for U.S. exports, thereby tending to reduce these exports. In addition, it acts like a subsidy on imports because it enables foreign exporters to charge lower dollar prices and still make a profit (on costs they have incurred in their own domestic currencies). However, as historical evidence reveals, there is little correlation between currency values and export performance. During the decade of 1970-80, while the German mark and Japanese yen appreciated, their merchandise export volume rose by 71 percent and 150 percent, respectively.

The related proposition, namely that the strong dollar has crippled our export industries can also be disproved if we examine the relevant trade data. When the annual data for 1982 and 1983 are compared, the numbers reveal that our merchandise exports in 1983 were indeed lower than in 1982. However, these data mask the recent pattern of change in our exports. To accurately capture the change in our export performance, quarterly data, not annual data, must be examined beginning from the last quarter of 1982 (the quarter in which the recession ended). Although our export performance in 1984 increased over $20 billion compared with 1983, we still have not achieved the levels attained in the 1970s. But, contrary to what has been said, U.S. exports have made an unusually strong contribution to our recovery and are growing 30 percent faster than they grew in the average of previous postwar recoveries. The surge in imports, however, has been significantly stronger than average.

The rapid rise in U.S. imports from Japan and the European and developing countries should not be viewed in a negative light. The strong dollar (and hence, our trade deficit) has fueled the recovery abroad and has enhanced the export earnings capacity of the less developed countries. Data Resources, Inc. estimates that half of Europe's anemic growth last year – and 55 percent of the growth of output worldwide – stemmed from export sales to the U.S. In 1983, the worldwide figure was 43 percent.

Ironically, the high value of the dollar has contributed to a narrowing of the trade deficit in some product accounts. The strong dollar as well as lower oil prices have shaved about $20 billion from the trade deficit with the oil-producing countries since 1981.

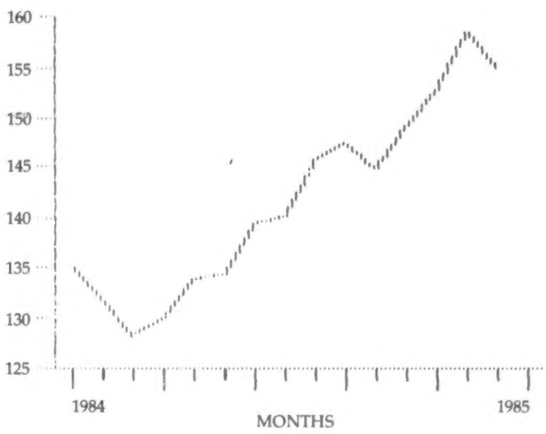
Are Official Interventions Useful?

A common European argument that is often heard is that the dollar could be checked by joint intervention of government financial authorities in the foreign exchange market. However, past evidence shows that official intervention has resulted in the loss of billions of dollars and has failed to stabilize exchange markets. Economist Dean Taylor cites the approximate $12 billion loss of the central banks of Canada, France, West Germany, Italy, Japan, Spain, Switzerland, Great Britain, and the U.S. during the 1970s to demonstrate this (*Official Intervention in the Foreign Exchange Market, or Bet against the Central Bank, Journal of Political Economy*, 1982). The volume of global currency transactions involving the U.S. dollar is not known with certainty. However, estimates fall in the range of $50 billion to $75 billion per day. Thus, the market is clearly too big for any central bank, or all the central banks together, to dictate for long any particular value of one currency in terms of another.

The Federal Reserve System and the U.S.Treasury have sold over $373 million in seven foreign exchange operations in the six months ending January 31. Despite the interventions, the trade-weighted value of the dollar still increased by eight percent (see Chart 1). Treasury Secretary Baker conceded that the interventions had some effect but could not keep the dollar from rising to new highs against other major currencies. Under the Reagan Administration, the U.S. has restrained from intervening except in cases of "disorderly" markets.

Another recent example of failed foreign exchange intervention by the major European central banks occurred on February 27. At one point, the dollar had plunged to a low of 3.18 marks from 3.99 on February 26 and 3.44 on February 25, reflecting anywhere from $500 million to as much as $1 billion in sales by the West German Bundesbank. Approximately $1 to $1.5 billion was unloaded in the foreign exchange markets by six central banks. But the intervention changed none of the fundamentals behind the dollar's strength. Indeed, following this concerted effort, the dollar recovered to 3.32 marks on February 28.

CHART 1
TRADE-WEIGHTED EXCHANGE VALUE
OF THE U.S. DOLLAR



From the time that exchange rates started to float to the end of the 1970s, the central banks systematically lost money in their attempts to manage the exchange markets, without having any visible impact. Between March 1973 and the end of 1978, Japan's loss was $2.9 billion through official intervention; Switzerland lost $63 million loss from the beginning of 1975 to the end of 1976; and Canada lost $19 million from June 1970 to the end of 1974. Clearly, the objective of intervention should be that of promoting economic efficiency, not of slowing exchange rate movements. As recent history has shown, intervention in the foreign exchange markets is not an effective method to alter currency values. It tends to be very costly to a nation's Treasury while having little effect on currency values.

Conclusion

The U.S. dollar remains strong against the currencies of the nation's major trading partners, despite efforts by governments on both sides of the Atlantic to drive it down. It is likely that the dollar's recent slide in the market is the result of an accumulation of bad news – particularly the preliminary indications of unexpected weakness in the U.S. economy during the first quarter, seemingly rising inflationary pressures, an unexpected drop in the money supply (as measured by M-1), and the banking problems in Ohio. Although the anticipated future path of economic activity in the U.S. remains strong, the outlook for our trading partners is also one of continued growth. Such an outcome, together with a continued decline in U.S. interest rates, can be expected to place downward pressure on the dollar. Any decline in the dollar's value, however, can only be expected to be gradual.

Leading businessmen and politicians have repeatedly asked in despair what can be done about the strength of the dollar. The free interplay of market forces will lead to continuing readjustments that reflect basic underlying economic and political considerations. In addition, more uniformly sound policies and greater convergence of the economic policies of major industrialized countries would help reduce current exchange rate tensions. These countries should be encouraged to follow the same sound economic policies–tax cuts, deregulation, and lower inflationary monetary policies–that have strengthened the U.S. economy.

CAPITAL COST RECOVERY AND TAX REFORM

*by David R. Burton**

The cornerstones of the Economic Recovery Tax Act of 1981 (ERTA) were dramatically reduced individual tax rates and the Accelerated Cost Recovery System (ACRS), both of which have been an unqualified successes.

The 25 percent across-the-board individual tax rate cut has broad political support. It is becoming more widely recognized that, despite the recession, the personal income tax cut reduced federal revenues by only three percent. Further, following the rate reduction the wealthy are paying both higher taxes and a higher proportion of the overall tax burden.

ACRS, however, has come under increasing political attack as opponents allege that it is an expensive, ineffective, and outmoded subsidy to capital intensive industries. Nothing could be further from the truth. The ACRS, combined with the investment tax credit (ITC), substantially reduced the tax bias against investment. Consequently, during the recession, investment declined at much slower rates than usual, and during the recovery, investment increased at record rates. This new capital is the key to sustaining high rates of economic growth and an increased standard of living for all Americans. The bottom line is that ACRS has worked beyond virtually everyone's expectations to spur investment and growth in the American economy.

What is the Accelerated Cost Recovery System?

Prior to ERTA, the U.S. depreciation system was extremely complex. The Asset Depreciation Range (ADR) system had over 125 different classes of equipment depreciable over different periods under varying declining balance rates (either the sum-of-the-years digits or straight line methods). Salvage value (the expected value of the asset at the end of the asset depreciation period) gave rise to additional complexities. Repair allowances and other considerations no longer relevant added still more complexity. Worse, these allowable depreciation ranges were inadequate and forced business to pay tax on illusory earnings.

The ACRS replaced this complex system with a simpler one consisting of four classes of property. Under ACRS, a taxpayer is allowed to deduct a percentage of the cost of his investment each year. The amount deductible is set forth in the easy to read table 1.

TABLE 1
THE ACCELERATED COST RECOVERY SYSTEM
(percentage recovered each year)

Recovery Year	Property Class 3-Year	5-Year	10-Year	15-Year
1	25	15	8	5
2	38	22	14	10
3	37	21	12	9
4		21	10	8
5		21	10	7
6			10	7
7			9	6
8			9	6
9			9	6
10			9	6
11				6
12				6
13				6
14				6
15				6

Three-year property includes automobiles, light trucks, tractors and certain other short-lived equipment. All other equipment falls under the five-year property category, while ten-year property refers to public utilities. Structures were recoverable in 15 years under the 1981 ACRS legislation; however, the Tax Reform Act of 1984 lengthened the recovery period to 18 years. The mere fact that one chart can describe the essence of ACRS is a testament to its simplicity.

Under ACRS, three-year property was eligible for a six percent investment tax credit and five-year property for a ten percent credit. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the ITC to four and eight percent, respectively.

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The Economic Basis of the Accelerated Cost Recovery System

During the decade of the 1970s, investment levels in the United States declined because ADR depreciation allowances had become woefully inadequate by almost any standard. The real after-tax cost of capital skyrocketed as inflation increased the replacement cost of machinery and equipment. Further, high interest rates reduced the present value of the stream of deductions allowed by the ADR system.

The difference between the allowable depreciation that could be claimed by corporations on their tax returns, and the cost of replacing that capital resulted in a significant overstatement of corporate profits during the past decade. As a result, it was characterized by diminished investment, declining rates of economic growth and falling productivity. From 1960 to 1970 the total value of goods and services produced by the U.S. economy increased by 47.3 percent, nearly a four percent annual rate of growth. This compares with a total increase of only 35.9 percent, a 3.1 percent annual rate, in the period from 1970 to 1980.

Between 1960 and 1970 the output per hour worked for all persons in the economy increased by 32.2 percent. This compares with a total increase in the following decade of only 14.6 percent, less than half the 1960s' increase. Between 1977 and 1980 U.S. output per worker actually declined by over one percent. This decline in worker productivity played a significant role in the double digit inflation rates experienced towards the end of the 1970s. Because there were no productivity gains to offset wage increases, most wage increases were translated into higher prices.

The ADR system was biased against capital investment. Although most business expenditures were fully deductible in the year incurred, capital costs had to be recovered over a dozen or more years. Consequently, investment in plant and equipment became less attractive than other forms of economic activity. Firms would distribute dividends rather than invest, or make investments other than in plant and equipment. By reducing the return to investment, ADR prompted individuals to consume more. Consumption was made relatively more attractive because, as the after-tax return to investment declined, the cost of consumption in terms of investment income foregone, was reduced.

This failing in the ADR system could be rectified by a neutral tax system that allowed capital expenses to be deducted in the first year just like any other business expense. Only a tax system that allows expensing of capital investment (or its equivalent) will eliminate the tax bias against investment in plant and equipment. ACRS, combined with the ITC, is almost equivalent to expensing on a present value basis. Table 2 below reflects the present value of ACRS and the ITC, adjusted for the 1982 reductions in the investment credit for different discount rates. A value of 100 represents expensing while values below 100 represent capital cost recovery allowances that are less adequate than expensing.

As the table demonstrates, present law is very similar to first year expensing with discount rates of about nine percent.

TABLE 2
PRESENT VALUE OF ACRS AND ITC

DISCOUNT RATE	ACRS-ITC 3 YR	ACRS-ITC 5 YR
12%	97.1	97.1
11	98.0	98.4
10	98.8	99.9
9	99.7	101.0

The Effect of the Accelerated Cost Recovery System

The Accelerated Cost Recovery System went into effect in 1981. Because of ACRS, by the third quarter after the start of the last recession investment had declined by only 7.5 percent, compared to an average decrease of 14.2 percent during the previous seven postwar recessions. Furthermore, in the first eight quarters of the current recovery, investment was up 32.4 percent. This was more than double the rate of increase reported in the last six recoveries that lasted this long, and triple the increase that characterized the three most recent recoveries (see table 3).

TABLE 3
CAPITAL FORMATION DURING THE RECOVERY

Year Recovery Began	8 Quarter Percentage Increase in Fixed Nonresidential Investment	Investment/GNP Ratio 8 Quarters After Trough
1949	21.4	9.3
1954	19.2	10.5
1958	15.3	9.7
1961	10.1	9.0
1970	15.3	10.4
1975	14.2	10.2
Average	15.9	9.7
Average since 1960	13.2	9.8
1982 (most recent)	32.4	12.5

At the end of the eighth quarter of the current recovery, the investment to GNP ratio had risen to 12.5 percent, the highest level in recent American history. This compares with an average ratio of 9.9 percent for the last six recoveries. The 2.6 percentage point difference in the ratio means that at the end of 1984, we were investing about $93 billion dollars more per year than typically occurred. In other words, investment was 25 percent higher than would have been expected at a comparable point in the recovery.

Capital Cost Recovery in the Context of Tax Reform

Every one of the tax reform proposals now before Congress would change the capital cost recovery system. Tax reform plans such as the Kemp-Kasten Fair and Simple Tax (FAST) plan or the Roth-Moore Broad-Based Enhanced Savings Tax (BEST) plan would replace the present capital cost recovery system with expensing or its equivalent. Less discussed plans, such as the Heftel Cash Flow Income Tax, the Siljander Ten Percent Flat Tax, or the Hall-Rabushka 19 percent flat tax introduced by Senators DeConcini and Symms, would also expense investment. But many reform plans—particularly the Bradley-Gephardt Fair Tax and the Treasury's reform package—would return to a depreciation system similar to, or even worse than, ADR. They would also, like every reform plan, repeal the investment tax credit. Consequently, they would dramatically raise the cost of capital and reduce investment levels.

The Kemp-Kasten Fair and Simple Tax plan would replace ACRS and the investment credit with the Neutral Cost Recovery System (NCRS). Assuming an inflation-adjusted discount rate of 3.5 percent, NCRS would provide the present value equivalent to expensing. This plan would also index the capital basis for inflation, and maintain the same basic classifications as ACRS. ACRS three-year property would become NCRS four-year property, ACRS five-year property would become NCRS six-year property and structures would be recoverable over a 25-year period (see table 4). NCRS would effectively eliminate the tax bias against savings and investment, unless real interest rates climb higher. Investment levels under Kemp-Kasten would stay at their present high levels and, in light of the FAST's other positive attributes, economic growth would accelerate substantially.

The Roth-Moore BEST plan would phase-in first year expensing by 1990 and phase-out ACRS and the ITC. By 1990, all ACRS three- and five-year property would simply be expensed in the first year. BEST shares with FAST the virtue of eliminating the tax bias against investment, but it is simpler than NCRS. Under the plan, a certain designated percentage of a property's basis is expensed while the remainder is recovered under present law. The applicable percentage set forth in the bill would begin at 50 percent in 1985 and reach 100 percent by 1990, rising by ten percentage points each year. Thus, in 1986, a taxpayer investing $1000 would deduct $600 and depreciate $400 under ACRS. The ITC would also be applied to the $400. Although a new bill that addresses the corporate tax is being seriously considered, Roth-Moore at present only reforms the individual income tax. The proposal has been certified, in writing, by the Joint Committee on Taxation as being revenue and distributionally neutral.

TABLE 4
NEUTRAL COST RECOVERY SYSTEM
(percentage recovered each year)

Recovery Year	4-Year	6-Year	25-Year
1	16	10	4
2	30	20	6
3	30	20	6
4	30	20	6
5		20	6
6		20	6
7			6
8			6
9			6
10			6
.			" "
.			" "
.			" "
25			" "
	106	110	148

The Bradley-Gephardt Fair Tax would replace ACRS and the ITC with the Simplified Cost Recovery System (SCRS). SCRS would return most property to lives of similar length to those under ADR. All property would be depreciable under a 250 percent declining balance method. The basis would not be indexed and recovery periods are as shown in table 5.

TABLE 5
SIMPLIFIED COST RECOVERY SYSTEM
(years)

ADR Class Life	SCRS Class Life
< 5.0	4
5.0 < 8.5	6
8.5 < 14.5	10
14.5 < 24	18
24 < 35	28
> 35	40

The Treasury Department has proposed replacing ACRS and the ITC with the Real Cost Recovery System (RCRS). RCRS would establish seven classes of property that bear no particular resemblence to the old ADR classes. The lives under the plan would be substantially longer and a standard percentage of remaining basis would be recovered each year (i.e. the plan establishes geometric decay assumptions in the tax law). As this kind of system would never allow a taxpayer to deduct the full value of his investment, it would essentially "close-out" the depreciation once 85 percent of basis was recovered. Capital basis would be indexed under the plan. Most ACRS three-year property would become five-year property, and most ACRS five-year property would become 17-year property. Structures would be recoverable over 63 years (see table 6).

TABLE 6
REAL COST RECOVERY SYSTEM

Period (years)	RCRS Close-Out Depreciation Rate
5	32%
8	24%
12	18%
17	12%
25	8%
38	5%
63	3%

Table 7 compares the effect of various proposals on the cost of capital with adjustment for the proposed changes in the corporate tax rate. In other words, the RCRS cost of capital calculations are done assuming a 33 percent tax rate and 50 percent dividend deduction (with half of after-tax earnings paid in dividends), as provided by the plan. Present law assumes a 46 percent tax rate; Bradley-Gephardt, a 30 percent tax rate; and Kemp-Kasten, a 35 percent rate. A figure of 1.00 equals expensing. A figure below 1.00 indicates that the system is better than expensing. A ratio greater than 1.00 shows the degree to which the cost of capital is increased. Thus a figure of 1.12 would indicate that under the plan, the cost of capital would be 12 percent higher than under expensing.

TABLE 7
COST OF CAPITAL UNDER VARIOUS TAX REFORM PROPOSALS

Recovery Method	Cost of Capital Inflation = 5% Real Discount Rate = 4%	Cost of Capital Inflation = 8% Real Discount Rate = 5%
ACRS-ITC 3 YEAR	1.00	1.03
ACRS-ITC 5 YEAR	0.99	1.04
ACRS 18 YEAR	1.36	1.44
NCRS 4 YEAR	1.01	1.02
NCRS 6 YEAR	1.01	1.04
NCRS 25 YEAR	1.05	1.15
SCRS 6 YEAR	1.05	1.07
SCRS 18 YEAR	1.15	1.18
SCRS 40 YEAR	1.24	1.27
RCRS 5 YEAR	1.02	1.03
RCRS 17 YEAR	1.08	1.09
RCRS 63 YEAR	1.20	1.22
EXPENSING	1.00	1.00

As the table shows, RCRS and SCRS substantially raise the cost of investing in plant and equipment while present law and NCRS are basically equivalent to expensing.

Policy Implications

Implementation of a capital cost recovery program like SCRS or RCRS would raise the cost of capital, reduce investment levels, lower productivity and make it difficult to sustain high rates of economic growth. This economically unjustified attempt to de-industrialize the U.S. economy would make it more difficult for American firms to compete internationally, reduce employment and ultimately, everyone's standard of living. The proper course is to enact a reform package that both reduces tax rates and provides adequate capital cost recovery allowances.

TRENDS IN COMMERCE NOTES ON TABLE II

April, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—The Department of Commerce's 'flash' estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—indicates that the growth rate may have slowed to a seasonally adjusted annual rate of 2.1 percent in the first quarter. The data appear to indicate that the consumer and government sectors continue to increase their spending, but that these increases are being offset by slowdowns in business investment and new home construction, and increases in imports. The revised estimate for fourth quarter economic activity reveals that GNP grew at an inflation-adjusted 4.3 percent annual rate, a slight downward revision from the estimate of 4.8 percent growth issued previously.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 1.2 percent in February, resulting in an 11.2 percent (seasonally adjusted annual rate) rise in the money supply in the latest three-month period.

This performance places the nation's money supply up 6.6 percent from its year-ago level. There is some speculation that the recent savings and loan closures in Ohio will result in a shift of funds from savings accounts (M-2), into checking accounts (M-1), and result in a short-term increase in the M-1 figures.

Employment—At 60.3 percent, the proportion of the adult population now working is higher than at any time in our history. Civilian employment—as measured by the monthly survey of households—increased by 434,000 persons (seasonally adjusted), in March to 107.1 million, bringing the employment increase in the last twelve months to three million. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 381,000 in March. This increase reflects the continued strength of service sector employment which rose by 280,000 workers, and a rebound in employment in the goods producing sector where over 100,000 more jobs were created in March than in February. The civilian unemployment rate remained unchanged at 7.3 percent in March, following a 0.1 percentage point decrease in February, and a 0.2 percentage point increase in January.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.3 percent in February following a 0.2 percent rise in January. The source of the February increase was to be found in the food, beverage, apparel, and housing components. Offsetting these increases was a sharp decline in gasoline prices and a modest decline in entertainment costs. Gasoline prices declined 2.5 percent in February and are now 17.3 percent below their peak level of March 1981. Food prices rose 0.5 percent in February due to an increase in fresh fruit and vegetable prices, resulting from adverse January weather.

Wholesale prices rose 0.2 percent in March after decreasing 0.1 percent in February. Although prices for food and energy fell in March, other consumer goods rose 0.6 percent, following a 0.2 percent increase a month earlier. The declines in energy and food prices were partially offset by increases in motor vehicles and other capital equipment. Prices at the wholesale level have increased in two of the last seven months and are unchanged from their level of last summer. The wholesale price index for finished goods in March was 0.3 percent higher than its year-ago level.

The more volatile part of the Producer Price Index, crude goods, declined 1.5 percent in March. Nearly all of the March drop was caused by a considerable decrease in the natural gas index, which had increased in February. Weak crude material prices appear to be a product of the strong dollar in international markets, and a surplus of farm products.

Housing Starts—The number of privately-owned housing units started in February declined to an annual rate of 1,638,000, 11 percent below the revised January rate of 1,841,000, and 26 percent below the number of starts a year ago. New single family homes were started at an annual rate of 1,121,000, up 6.7 percent from January. This represents the highest rate of single family starts during the past ten months. Building permits issued in February were down five percent from January, following three consecutive months of increases.

Industrial Production—Industrial production declined 0.5 percent in February, following a reported 0.3 percent increase in January. The February data indicated declines in all major sectors of the economy except for the defense and space industries, which increased output by 0.8 percent for the month.

The capacity utilization rate for manufacturing declined 0.6 percentage points in February as factories operated at 80.8 percent of capacity. Although the capacity utilization rate was at about the same level as a year ago, output has increased by 2.9 percent. This increase in output was due to a continued rise in available capacity and a higher level of investment.

Productivity—Revised data on productivity indicates that business productivity increased at a 3.8 percent annual rate in the fourth quarter of 1984. This resulted from a 5.5 percent increase in output, along with a 1.6 percent increase in the number of hours worked for all persons. This was a significant increase from the third quarter when productivity rose only 0.6 percent. At the same time, hourly compensation, which includes wages, salaries, supplements, and all employer payments to employee benefit plans, increased at a 4.4 percent annual rate. The more rapid rise in hourly compensation compared to productivity resulted in an increase in fourth quarter unit labor costs of 0.6 percent.

Interest Rates—At 10.5 percent the prime rate has remained virtually unchanged for nearly three months. Both short- and long-term rates declined in March. Three month Treasury bills which were 8.94 percent on March 1st fell to 8.32 percent by April 12th. Similarly, the 90-day commercial paper rate fell from 9.2 percent to 8.75 percent, while the federal funds rate fell from 8.74 percent to 8.47 percent. Thirty year U.S. Treasury bonds fell from 11.82 percent at the beginning of March to 11.4 on April 12th.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicates that failures were rising toward the end of the month. The index of business failures, which uses October 1983 as a base of 100, increased to 94.4 in the week ending March 8, 1985.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Jan/85	238.0	237.8	235.8	0.1	0.9
Gross National Product ($B) [a]	I/85	3,828.2	3,758.7	3,553.3	1.8	7.7
Gross National Product (72$B) [a]	I/85	1,671.2	1,662.4	1,610.9	1.0	5.7
Money Supply (M1) ($B) [a]	Feb/85	569.3	562.7	534.2	1.2	6.6
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Feb/85	2,451.9	2,433.7	2,267.6	0.7	8.1
Personal Consumption Expenditures (72$B) [a]	Jan/85	1,085.9	1,085.0	1,052.8	0.1	3.1
Disposable Personal Income ($B) [a]	Feb/85	2,680.4	2,673.3	2,504.5	0.3	7.0
Disposable Personal Income (72$) [a]	Jan/85	1,192.9	1,192.3	1,141.8	0.1	4.5
Personal Savings Rate (%)	Jan/85	5.6	5.9	5.6	−0.3[b]	0.0[b]
Civilian Employment (millions) [a]	Mar/85	107.1	106.7	104.1	0.4	2.9
Civilian Unemployment Rate (%) [a]	Mar/85	7.3	7.3	7.8	0.0[b]	−0.5[b]
Average Hourly Earnings [a]	Mar/85	$8.54	$8.50	$8.25	0.5	3.5
Consumer Price Index (All Urban, 67 = 100)	Feb/85	317.4	316.5	306.7	0.3	3.5
Purchasing Power of the Dollar (1967 = $1.00)	Feb/85	0.315	0.316	0.326	−0.346	−3.368
Prime Interest Rate (%) April 4, 1985		10.5	10.5	11.5	0.0[b]	−1.0[b]
Retail Sales ($) [a]	Mar/85	110.5	112.7	104.5	1.9	5.8
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	IV/84	230.6	224.8	225.5	2.6	2.3
After Tax	IV/84	142.3	141.7	141.1	0.4	0.9
Industrial Production (67 = 100) [a]	Feb/85	164.7	165.5	160.0	−0.5	2.9
Capacity Utilization Rate (Mfg.) (%)	Feb/85	80.8	81.4	80.9	−0.6[b]	−0.1[b]
New Housing Starts (thou. units) [a]	Feb/85	1,638.0	1,841.0	2,208.0	−11.0	−25.8
Net Business Formation (67 = 100)	Feb/85	118.0	117.3	117.2	0.6	0.7
New Business Incorporations (Thousands) [a]	Sep/84	51.9	51.7	50.4	0.3	2.9
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100) [a]	IV/84	159.8	159.5	157.1	0.2	1.7
Unit Nonlabor Costs (77 = 100) [a]	III/84	154.5	152.3	150.9	1.4	2.4
Producer Price Indices (67 = 100)						
Crude Materials [a]	Mar/85	311.5	316.1	337.1	−1.5	−7.6
Intermediate Goods [a]	Mar/85	318.4	318.9	319.6	−0.2	−0.4
Finished Goods [a]	Mar/85	292.7	292.1	291.5	0.2	0.4
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100) [a]	Feb/85	569.9	585.0	519.8	−2.6	9.6
Federal Government Debt Outstanding ($B)	Dec/84	1,667.4	1,635.5	1,415.3	2.0	17.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	IV/84	367.2	368.6	346.1	−0.4	6.1
Imports of Goods & Services ($B) [a]	IV/84	423.2	459.3	375.9	−7.9	12.6
Balance on Goods & Services ($B) [a]	IV/84	−56.0	−90.7	−29.8	−38.3	87.9
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100)	Feb/85	167.5	166.4	166.5	0.7	0.6

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

This was slightly below the 96.4 index for the business failure index reported a year ago. However, the number of March business discontinuances was significantly above the year ago level. From January to mid-February the number of business discontinuances was about the same as in 1984.

The latest available data indicates that there were 478,398 new business incorporations in the first nine months of 1984, a six percent increase over the same nine month period in 1983. After seasonal adjustment, the number of new business corporations formed in September of 1984 increased 0.3 percent from the previous month. The states with the largest of year-to-year increase in new business corporations were Vermont (up 26.5 percent), Maryland (up 25.8 percent) and Arkansas (up 20.5 percent). Regionally, New England showed the largest gain for 1984 compared to 1983, with new incorporations up over 13 percent from a year ago. At the current rate, new business incorporations in 1984 will exceed 635,000 for the year—a significant increase over the 600,400 new corporations formed in 1983 which was a record year.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, rose by 9.4 percent this February compared to its year ago level. In the first five months of fiscal 1985, federal expenditures increased 11.8 percent, about three times as fast as prices, indicating a real increase in federal spending of about eight percent from the year ago level. Only one-fifth of the increase is the result of rising defense spending. Receipts for the month of February were up 12.8 percent from the same month a year ago due to large increases in personal income and social insurance tax receipts. Receipts for the first five months of the fiscal year are up 11.9 percent and are rising faster than income. The double digit rise in federal outlays, despite rather modest inflation, indicates that the deficit problem is the result of uncontrolled federal outlays rather than inadequate tax revenues.

Personal Savings—According to Department of Commerce data, personal savings fell in the first two months of 1985. Savings declined to about 5.5 percent of after tax income from 6.2 percent in the fourth quarter of 1984. Personal savings in 1984 were nearly $40 billion higher than they were in 1983, with the percentage of income saved increasing from 5.0 percent in 1983 to 6.1 percent in 1984. This means that sixteen percent of the increase in after-tax income in 1984 went into savings.

Retail Sales—Retail sales dropped 1.9 percent in March following a 1.6 percent rise in February. Although the month-to-month decline was the largest in seven years, it came on the heels of an unusually strong rise in sales in February. The February rise was indicative of an across-the-board increase in sales in most major retail sectors. The March department store sales figures show a 4 percent drop in auto sales and a 2.3 percent decline in department store sales. But those unusual declines follow large increases in February of 1.7 percent in autos and five percent in department stores. Meanwhile most major retail chain stores. aided by an early Easter, showed strong year-to-year sales increases for March.

Trade Deficit—The trade deficit, on a goods and services basis, decreased from an annual rate of over $90.6 billion in the third quarter to a revised 56.0 billion in the fourth quarter. The improvement is the result of a $13.6 billion increase in net exports compared with a decrease of $15.6 in third quarter exports. The fourth quarter data also reflected a large decrease in imports compared to the third quarter when imports were rising. The deteriorating international trade position of the U.S. is best exhibited by the fact that the deficit for goods and services which was $64.2 billion in 1984, was only $8.3 billion in 1983, following surpluses in 1981 and 1982. The monthly data on merchandise trade show a deficit of $11.5 billion in February. The increase in the merchandise trade deficit, which occurred in spite of a 1.3 percent decline in imports, resulted from a sharp (eight percent) drop in exports.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.7 percent in February, with five of the ten available indicators up. This follows a revised 1.5 percent increase in January. The index has now risen for three successive months.

NATIONAL CHAMBER FOUNDATION TAX STUDIES UNDERWAY

The National Chamber Foundation (NCF) will soon complete two important tax studies that provide analysis crucial to the current debate on reforming the U.S. tax system.

The first study, by Dr. Michael Boskin of Stanford University, examines how the Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC) have contributed to capital formation, investment, and productivity.

The second study, by Dr. Gregory Ballentine, formerly chief economist at the Office of Management and Budget (OMB), examines the level of *all* taxes paid by corporations to determine the effective corporate tax rate. Accurate data in this area is needed for critiquing any proposed shifts in the tax burden.

The business community and key policymakers will be invited to hear the findings of these NCF studies at a conference scheduled in early June. Those interested should contact Ms. Gale Thompson at (202) 463-5552.

The National Chamber Foundation is a non-profit, public policy research organization affiliated with the U.S. Chamber of Commerce.

ACCRA COST OF LIVING INDEX

The American Chamber of Commerce Researcher's Association, (ACCRA) publishes intercity cost of living comparisons for some 200 cities in the country. The ACCRA index has appeared on a quarterly basis since 1968, and the mix of cities varies from quarter to quarter. The following table presents the latest data from the ACCRA's fourth quarter 1984 cost of living index for 20 cities picked at random. The average for all participating cities is 100; therefore, a value of 145.9 for San Francisco is interpreted as meaning that the cost of living in that city is 45.9 percent above average. Similarly, a value of 96.6 for Greensboro means that the cost of living in that city is 3.4 percent below the average for all the communities listed. For more information about cost of living statistics, contact the Lexington Chamber of Commerce, Lexington, Kentucky, (606) 254-4447.

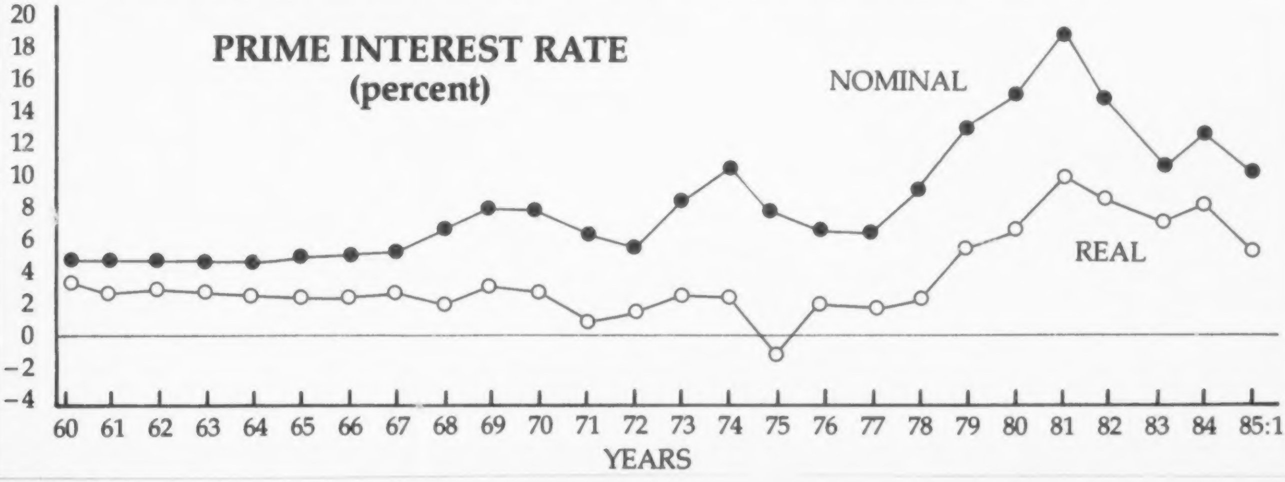
San Francisco, CA	145.9
Anchorage, AK	136.5
New York, NY	134.4
Fairfield, CT	122.9
Boca Raton, FL	118.2
San Diego, CA	113.4
Seattle, WA	110.5
Denver, CO	109.6
Kalamazoo, MI	105.1
Pittsburgh, PA	104.4
Des Moines, IO	102.1
Birmingham, AL	101.7
Tucson, AZ	99.8
Oshkosh, WI	99.3
Greensboro, NC	96.6
Huntsville, AL	94.3
Fort Smith, AR	92.4
Joplin, MO	90.9
Pueblo, CO	88.4
Clinton, MO	88.3

ECONOMIC OUTLOOK AVAILABLE ON MICROFICHE

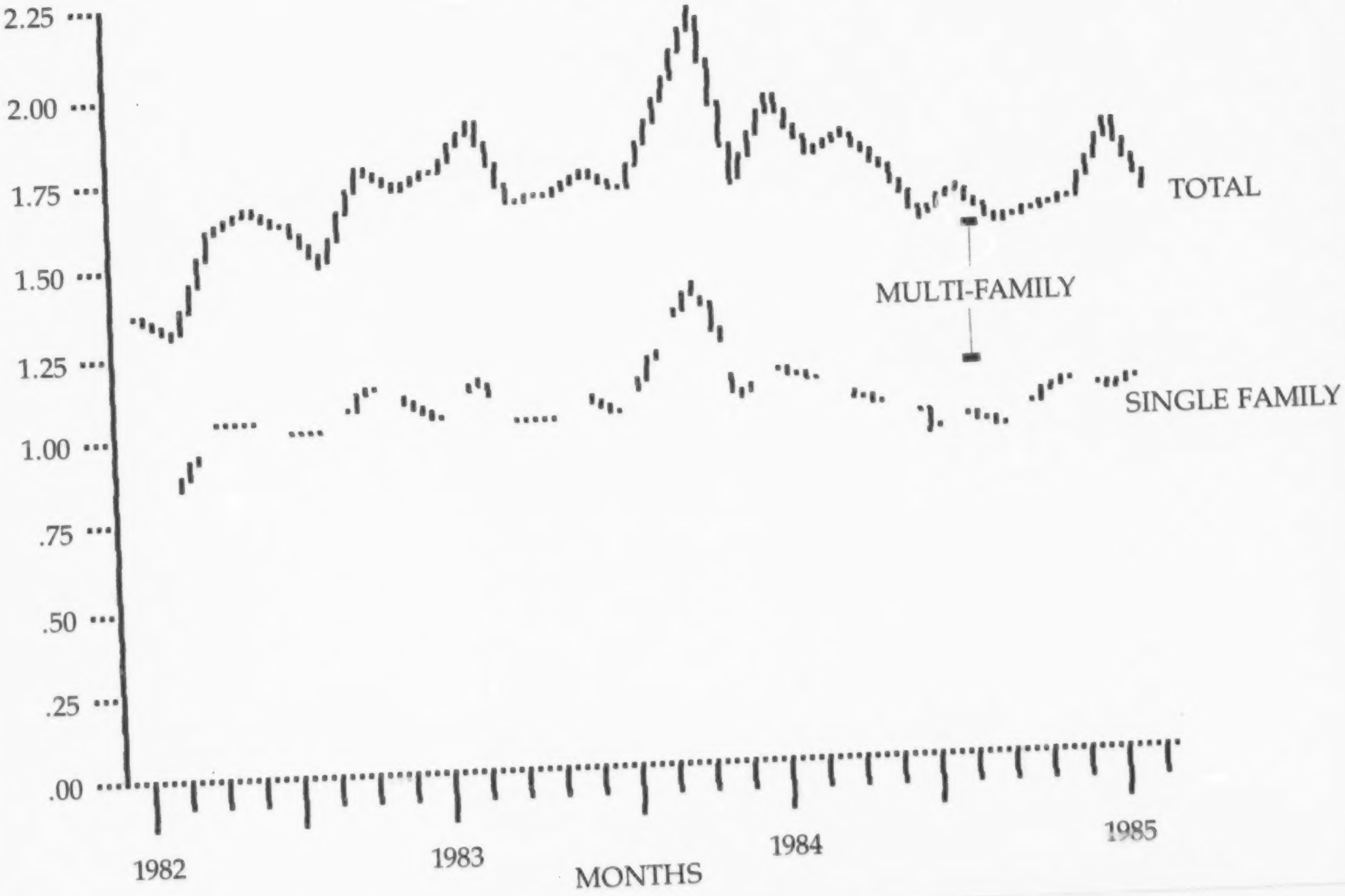
ECONOMIC OUTLOOK is available on microfiche in the Statistical Reference Index collection maintained by the Congressional Research Service. For information concerning this service, please write or call Congressional Information Service, Inc., 4520 East/West Highway, Bethesda, MD 20814, (301) 654-1550.

THE NOMINAL AND REAL PRIME INTEREST RATE

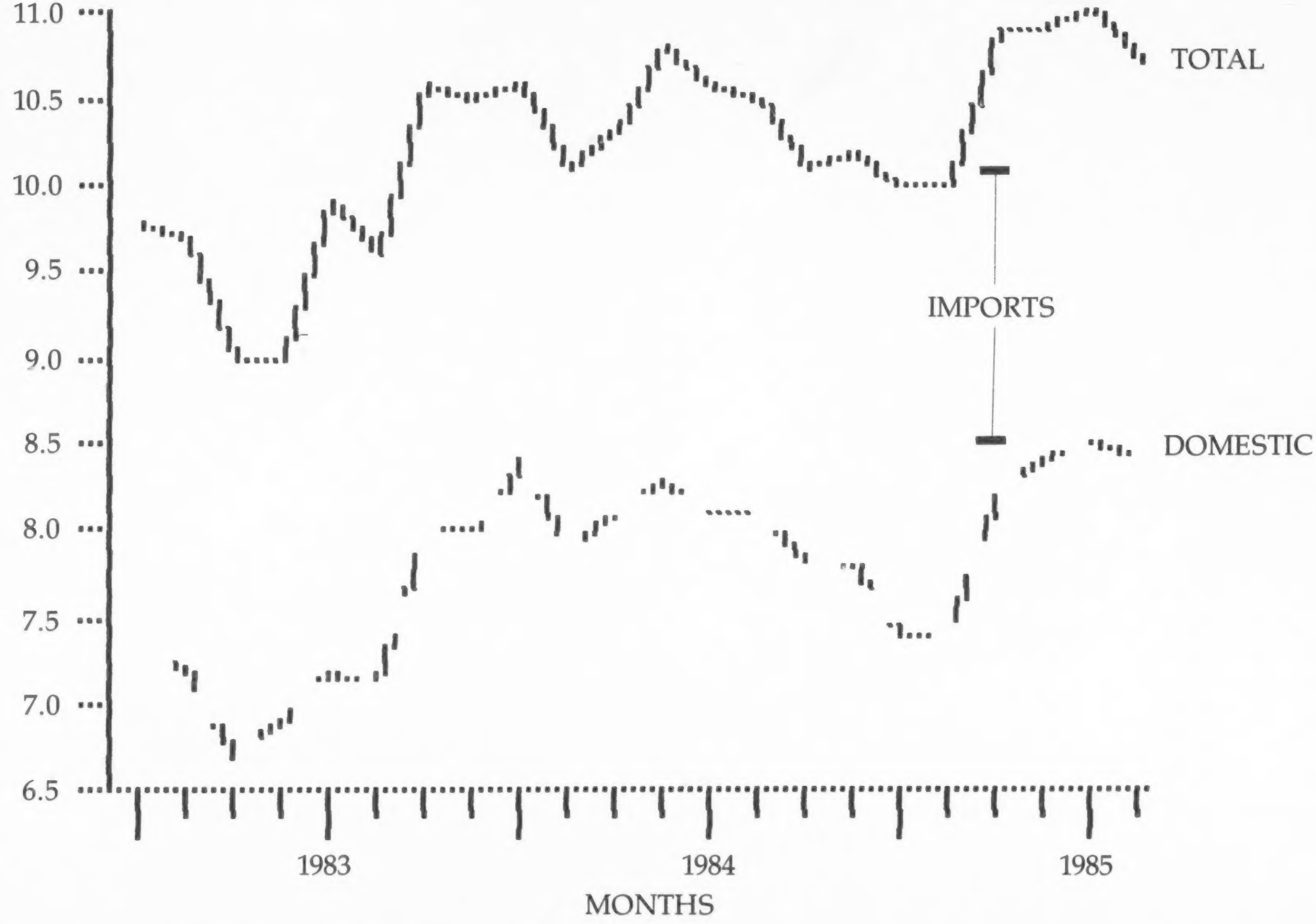
Although the real rate of interest is a key economic variable, it cannot be directly observed. A crude measure of it is derived by subtracting the rate of change in overall inflation (i.e. the implicit price deflator for GNP), from the nominal interest rate. The chart shows the nominal and real prime rate since 1961. The nominal prime rate peaked at 18.9 percent in 1981 and has retreated steadily since then, averaging 10.5 percent since mid-January. As of the first quarter of this year, the inflation rate was at its lowest point since 1977, the nominal prime interest rate was at its lowest point since 1978, and the real prime interest rate, at its lowest point since 1979.



NEW HOUSING STARTS
(Millions)



SALES OF NEW CARS
(Millions)



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ECONOMIC OUTLOOK

Chamber of Commerce of the United States May 1985

BUSINESS INVESTMENT STILL THE MAINSTAY OF OVERALL ECONOMIC ACTIVITY

by
Richard W. Rahn and Graciela Testa-Ortiz

The anemic growth rate in real GNP during the first quarter makes the final resolution of the budget impasse all the more imperative. We can no longer afford to waste time; the problem of runaway federal spending growth needs to be addressed in an effective manner, one which will lay the groundwork for a continuation, and indeed, a strengthening, of the more than two years of economic expansion that we have, so far, enjoyed. This article presents a detailed discussion of the strengths and weaknesses now apparent as the business expansion continues through its third year. Our forecast still foresees a continuation of stable, noninflationary growth in the nation's economy. However, less welcome alternatives have become increasingly likely, as the article that follows explains.

Accounting for Recent Economic Performance

The first quarter posted the lowest rate of growth in economic activity since the recovery began, a development that we, as well as other forecasters, failed to fully anticipate. However, the reported measure of real GNP hides some of the economy's strengths. The real picture begins to emerge only when overall GNP is disaggregated by components. Then we see that the real problem during the past three quarters has been the extreme volatility of imports. Real imports rose at a seasonally adjusted, annual rate of 55.4 percent in the third quarter of 1984. This was followed, in the fourth quarter of 1984, by a 28.3 percent decline in the growth rate; and, in the first quarter of 1985, by a 26.2 percent increase. Excluding net exports from real GNP shows that domestic demand remained strong, rising by 4.4 percent during the first quarter. Chart 1 shows the discrepancy between the growth rates of real gross national product and GNP minus net exports since 1983. While this gap shows the extent to which imports have sapped U.S. growth, it also shows that domestic demand has been, and remains, fairly healthy, surpassing GNP growth in every quarter, with the exception of the last quarter of 1984.

Other components of real GNP have continued to grow at a fairly strong rate. In particular, real consumer spending rose by 4.7 percent in the past quarter, the highest growth rate in three quarters. Similarly, investment in nonresidential structures rose by 16.2 percent, the fifth double-digit increase in the past six quarters. However, the remaining three components of GNP—residential investment, equipment investment, and government purchases—did post declines. Inasmuch as we believe that the rate of growth in federal outlays needs to be curtailed, the 0.9 percent decline in government purchases of goods and services during the first quarter is a welcome occurrence, even if it reduced measured GNP.

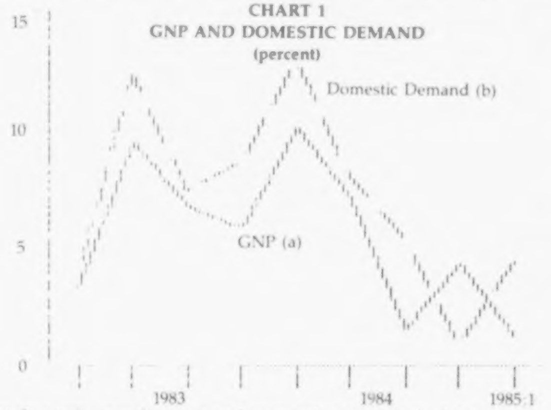

CHART 1
GNP AND DOMESTIC DEMAND
(percent)

(a) Quarterly growth rate in real gross national product, at an annual rate.
(b) Quarterly growth rate in real gross national product minus real net exports, at an annual rate.

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Nevertheless, first quarter activity would have been stronger if monetary policy had been held to a steadier course. The nation's money supply, as measured by M(1), rose by three percent between January and June 1984, but then decelerated to a growth rate of only 1.2 percent between June and November of 1984. Because growth in the money supply leads growth in nominal GNP by six to eight months, the deceleration in money supply growth between June and November of last year, was reflected in the very weak rate of economic growth registered during the first quarter of this year. Fortunately, relatively stronger money supply growth has resumed – M(1) rose by 3.3 percent between November 1984 and March 1985 – presaging a resumption in real economic growth during the remainder of this year.

Rising Confidence Buoys Consumer Spending

While consumer demand was the strongest contributor to an otherwise lackluster first quarter, there remain concerns regarding the future strength of this sector. Although growth in spending for consumer durables (the most volatile component of consumer spending), and nondurables is greater than any peak since the 1960s, growth in some consumption categories has begun to falter. In particular, growth in spending for furniture, other consumer durables, food, clothing, and fuel, which rose faster than average during the first year of recovery, are no longer doing so. Further, in February, consumer spending outpaced income growth for the fourth consecutive month. This imbalance between spending and income, which leads to greater consumer indebtedness, could not be sustained for long, and indeed, it may have already ran its course. In March, consumer spending fell by 0.5 percent, the result of a 1.2 percent drop in spending on goods and a sharp drop in expenditures for household operation. Also, while the debt-to-income ratio has remained stable, at approximately 17.5 percent, for three consecutive months, and is below the previous peak of 17.8 percent, it is high by historical standards and may limit future spending growth.

Nevertheless, we believe that the strength of consumer spending is far from over. After ten quarters of recovery, overall consumer spending has increased 1.6 percentage points faster than the average for the past five postwar recoveries. Although March consumption fell, part of that decline was due to a circumstance that is independent of consumers' attitudes and buying intentions, namely, a falloff in spending for household services, including electricity and utilities. This category of expenditures is largely shaped by weather patterns rather than consumer choice.

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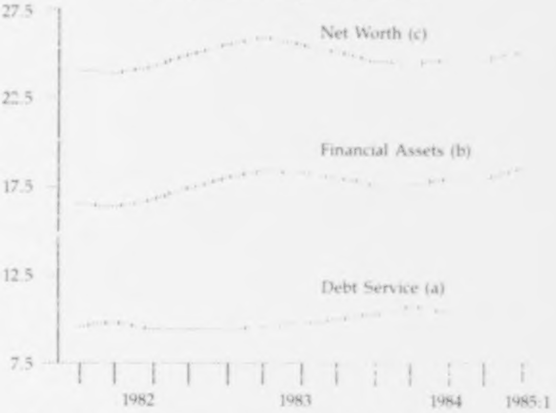
Other indicators of future consumption activity point to a relatively optimistic outlook. While, as we noted, household debt as a percentage of income is high, the willingness of consumers to acquire debt reflects households' confidence in the future of the economy. Further, the strength of household balance sheets could offset pressures stemming from the high debt burden. Chart 2 shows that interest payments on household debt as a percent of disposable income have remained stable for the past three years. Moreover, it shows that both the net worth and the financial assets of households are strong and rising. Real household financial assets rose by 8.6 percent in 1983 and 6.2 percent in 1984, and are projected to increase by 8.6 percent this year.

CHART 2
MEASURES OF HOUSEHOLD DEBT AND WEALTH
(as a percent of disposable income)



(a) Household ratio of interest payments on debt to disposable income (flow of funds data).

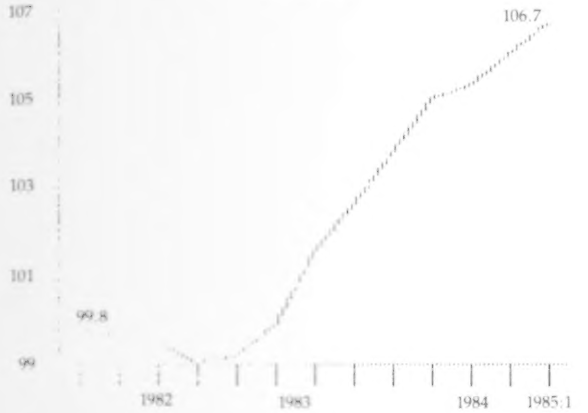
(b) Household financial assets outstanding as a percent of disposable income (flow of funds data)

(c) Household net worth (net of depreciation) as a percent of disposable income (flow of funds data).

Personal income also continues to grow. Since September 1984, the monthly increase in personal income has averaged 0.5 percent and fluctuated only slightly about that average. Reflecting the strength of employment growth, the largest increase in March personal income was in the wages and salaries category. Although March after-tax income fell by 0.5 percent, this outcome is considered a fluke caused by the delay in mailing out income tax refund checks. Had tax refunds been on schedule, disposable income would have increased by 0.3 percent in February and 0.4 percent in March. While the unemployment rate remained at 7.3 percent in April, employment gains have been strong. American private industries have created more than one million new jobs since December 1984 (see Chart 3).

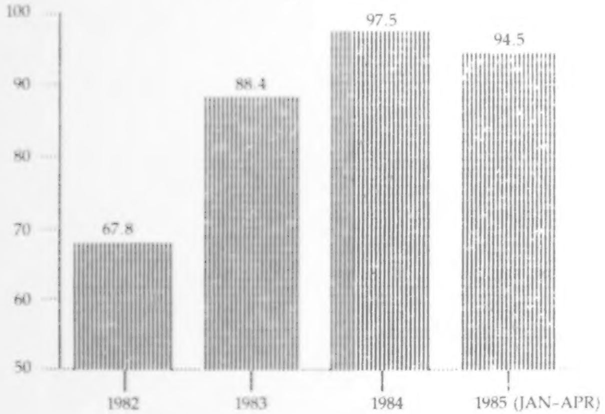
Interest rates are another important determinant of consumption, particularly for spending on big ticket items such as automobiles and furniture (which are typically bought on credit), as well as attitudes regarding the economy's future. Again, the latest data are encouraging. The three month Treasury bill rate, which was 8.94 percent on March 1st., fell to 7.98 percent by May 3rd. Similarly, other short-term interest rates declined: the 90-day commercial paper rate fell from 9.2 percent to 8.43 percent during the same period, while the federal funds rate fell from 8.74 percent to 8.19 percent. Long-term interest rates also fell, although not by as much. Thirty year Treasury bond rates fell from 11.82 percent to 11.3 percent. The prime rate remains at 10.5 percent but is expected to fall soon.

CHART 3
CIVILIAN HOUSEHOLD EMPLOYMENT
(millions)



Finally, consumer attitudes and buying intentions remain fairly strong. The recent decline in interest rates has already resulted in a change for the better in this important determinant of consumer spending. The index of consumer confidence rose to 94.6 in April from 93.7 in March (see Chart 4). Nowhere is the upbeat attitude of consumers as evident as in domestic automobile sales.

CHART 4
CONSUMER SENTIMENT INDEX (a)
(February 1966 = 100)



(a) Not seasonally adjusted.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Sales of new domestic automobiles reached 9.9 million units in the second ten selling days of April, and averaged 8.7 million units for the month as a whole, the highest selling rate for any month since 1979. While, the spurt in domestic car sales may have been influenced by the pending termination of subsidized financing programs, sales of models not included in these programs have also been strong, suggesting that underlying demand may be rising. Further, there is some evidence of a shift away from imports to domestic automobiles. Sales of new imported automobiles averaged 2.4 million units in 1984, bringing the import share of total car sales down to 23.6 percent from 26 percent in 1983. This trend continued in early 1985, with the import share falling further, to 21.7 percent, in the first quarter. However, a dark cloud on the horizon for domestic car sales lies in the forthcoming increase in imports of Japanese cars. Industry calculations place the increase in foreign penetration in the automobile market at 300,000 units this year, and an additional 400,000 units in 1986. The resulting increase in competition will benefit consumers as it is likely to result in downward price pressures.

The outlook for consumer purchases, including auto sales, remains relatively strong as falling interest rates, continued moderate increases in real disposable income and employment buoy consumer attitudes. This month's forecast anticipates increases in inflation-adjusted consumer spending of 3.9 percent in 1985 and 3.8 percent in 1986. Sales of new cars, domestic and imported, are anticipated to reach the eleven million unit level by the end of this year, compared to 10.5 million in 1984 and 9.2 million in 1983.

Housing Boom Continues

Residential investment has been one of the most vibrant sectors of the U.S. economy since the recovery began at the end of 1982. Since then, it has risen by 60.6 percent, two and a half times faster than average and almost five times faster than the increase in real GNP. First quarter housing starts averaged almost 1.8 million units, significantly above the 1.6 million unit average for the last quarter of 1984 (see Chart 5). March starts rose by 16.2 percent to 1.895 million units, largely due to a pick up in multi-unit structures; however, single family home starts continued on the upward trend begun last September. New single family home sales jumped by 8.9 percent in March, reaching their highest level since February 1984.

The March rise in starts may reflect erroneous perceptions that mortgage interest rates have bottomed out, since the March consumer sentiment survey showed a substantial rise in the proportion of respondents expecting interest rate increases in coming months. In fact, however, mortgage rates fell from the six-quarter peak of 14.11 percent reached in the third quarter of last year, to 12.73 percent in the first quarter of 1985 (see Chart 6), and are expected to fall to 12 percent by the end of this year.

The housing affordability index, a measure of households' ability to meet the income requirements to qualify for a mortgage loan, has risen of late and is expected to continue doing so. This means that the number of qualifying households has increased. A one percentage point decline in mortgage interest rates increases the number of households able to qualify for a mortgage loan by 400,000 to 500,000; seventy-five percent of which translates into home sales. This suggests that the continued slide in mortgage interest rates that we expect during the remainder of this year, will raise home sales by 350,000 units.

CHART 5
TOTAL NEW HOUSING STARTS
(millions)

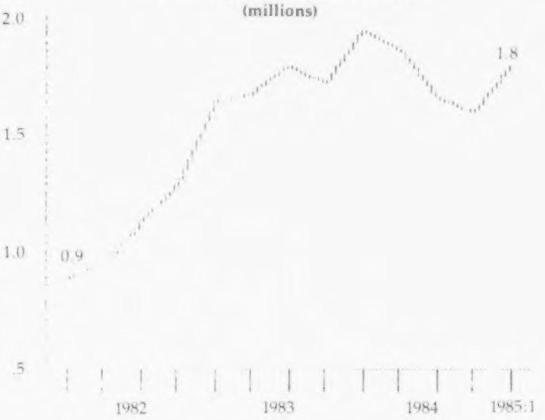
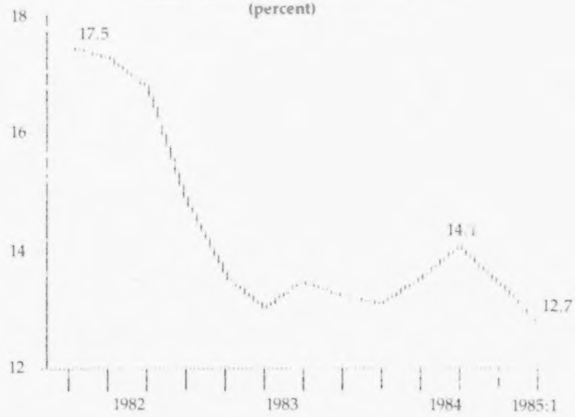


CHART 6
MORTGAGE INTEREST RATE (a)
(percent)



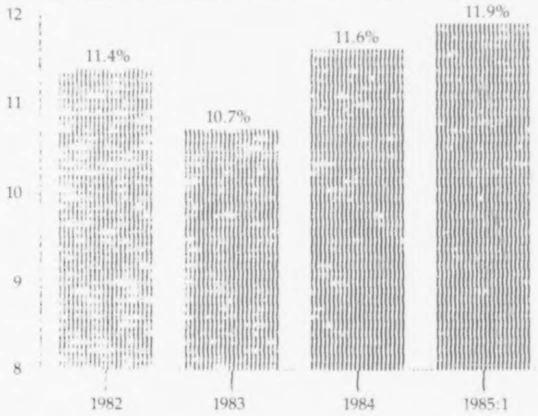
(a) Effective conventional commitment mortgage rate, combined lenders, 25-year, 75 percent loan.

Total building permits for March rose a strong 11 percent to 1.8 million, the highest level of permits in the past 12 months. Since permits lead starts by about six months, this indicates that we can look forward to a summer of continued strength in the housing sector. We anticipate that housing activity will remain strong throughout the forecast interval. New starts are expected to average 1.9 million units by the end of this year.

Business Fixed Investment: Still the Leader

Business fixed investment has also been a mainstay of the economy's growth. In the past ten quarters, it rose by 31.5 percent, almost twice as fast as the recovery average and two and a half times faster than real GNP. There are indications, however, that this sector is settling down. Investment gains in the first half of 1984 were 21 percent, but only 8.5 percent in the fourth quarter. Preliminary estimates for the first quarter of this year place the increase in nonresidential investment at only 3.2 percent. However, the ratio of nonresidential investment to GNP reached 11.6 percent in 1984 compared to a low of 10.4 percent in the second quarter of 1983. It continued rising during the first quarter of this year, reaching an eleven-quarter peak of 11.94 percent (see Chart 7), and is expected to reach 13.1 percent by the end of 1986.

CHART 7
BUSINESS FIXED INVESTMENT AS A PERCENT OF GNP



Several developments, in particular, the decline in interest rates of the past two months, buoy this sector. The expected continuation of the downward trend in interest rates will further reduce the cost of capital and enhance investment. Despite the inroads that imports continue to make in domestic markets, domestic demand remains strong (see Chart 1 above).

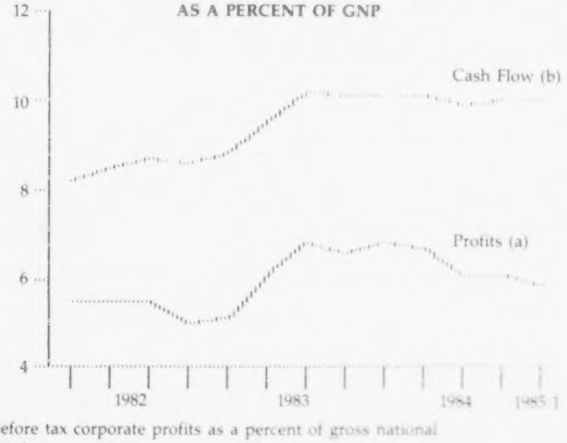
Nevertheless, the impact of import penetration should not be underestimated. While growth in equipment investment has been extraordinarily strong, historical comparisons show that growth in the production of business equipment parallels investment gains. This time around, however, output of final business equipment has risen by 23.1 percent, compared to 16.7 percent for the average of the past four recessions; while investment has risen by 40.7 percent compared to an average increase of 18.2 percent. The gap between production and investment is evidence of import penetration. Industrial production rose by 0.3 percent in March, recovering from the February decline, but output is still 0.4 percent below last summer's peak.

Slowing sales, plus the need to contain inventories can lead to a slowdown in industrial production growth and a decline in the rate of capacity utilization, reducing corporate profits and cash flow. Inventory accumulation, which has gone on steadily for almost two years, increased by 0.4 percent in both January and February. However, the rate of growth has slowed since October. Part of the increase was intentional and can be discounted, as it primarily reflected the restocking of automobiles, which accounts for half of the January increase in inventories. Defense orders also played a significant role in the recent inventory build up because of the long production lags and cost plus nature of the sector. Defense orders have grown one and a half times faster than total manufacturing orders since 1978 and now account for 37 percent of unfilled orders. Some unwanted accumulation occurred in the nondefense capital goods sector.

An inventory correction is probably taking place now, although its magnitude should not be worrisome. In keeping with recent experience, business accumulation of inventories will remain cautious. Businesses seem determined to minimize the inventory-to-sales ratio and the past damage to profits induced by inventory cycles has reinforced this strategy.

Both profits and cash flow remain relatively strong (see Chart 8). Before tax corporate profits stand at about six percent of GNP and are anticipated to remain within that range throughout the next two years. Net cash flow reached ten percent of GNP in 1984, compared to 9.6 percent in 1983 and 8.5 percent in 1982. During the fourth quarter of 1984, profits increased at an annual rate of 16 percent, buoyed by very large gains in the profits of nonfinancial corporations. In that same quarter, the financing gap – the difference between capital expenditures and corporate cash flow, with book value depreciation allowances – was zero, implying that nonfinancial corporations, on average, were able to finance all of their capital investment out of internal funds. Profits from current production have been robust for two years. After-tax profits, on the other hand, have done poorly, but this largely reflects accounting changes. The impact of accelerated depreciation reduces taxable profits but adds significantly to cash flow.

CHART 8
CORPORATE PROFITS AND CASH FLOW
AS A PERCENT OF GNP



(a) Before tax corporate profits as a percent of gross national product.

(b) After-tax corporate profits plus book value capital consumption allowance minus dividends, as a percent of gross national product.

There is some evidence of a future slowdown in fixed investment, stemming largely from nonresidential building. Investment in nonresidential structures is expected to weaken in the next few quarters because office and commercial building, the mainstay of nonresidential building, is faced with very high vacancy rates in some locations. Nevertheless, several long-term incentives to nonresidential investment remain strong. Particularly important is the capital replacement need that this country faces. The nation's net effective capital stock in 1985 should be slightly higher than in 1979, but still below the level of the 1960s. To remain competitive, and in fact, increase their international competitive position in order to adequately defend themselves from imports, American industries will need to sustain a high level of investment to boost productivity and improve quality. Finally, as a further spur to capital investment, the relative cost structure of production continues to point to the substitution of capital for labor.

Other indications of the relative strength of future investment involve recent evidence on shipments and new orders of durable goods. After eight months of erratic movements, new orders for nondefense capital goods rebounded sharply (29.6 percent) in February, reaching a new peak and, in part, contributing to a 5.4 percent increase in March shipments. Although new orders for nondefense capital goods declined in March, new orders for defense capital goods and household durables rose by 24 percent and three percent, respectively.

Net Exports: Still the Sour Note, but Slowly Improving

The U.S. current account has swung from a surplus in the spring of 1982 to a deficit of $102 billion in 1984. During the past ten quarters, real imports have risen by 41 percent, almost twice as fast as the average recovery experience, while real exports have actually declined by 1.8 percent, compared to an average recovery increase of 21 percent. The March merchandise trade deficit held steady at $11 billion. In spite of the recent month-to-month swings in exports and imports, the merchandise trade deficit has remained in the neighborhood of $11 billion a month over the past year.

The factors contributing to the continuing rise in our balance of payments deficit have been discussed often in these pages. They include: the high value of the dollar, which makes foreign goods relatively less expensive than American goods; differences in recovery cycles between the U.S. and its major trading partners, which have constrained the foreign demand for U.S. goods; the debt crisis faced by the developing nations, which has resulted in a sharp cutback of imports by these nations as they attempt to increase their foreign exchange earnings to service their massive foreign debt; and the problems faced by the OPEC nations, i.e. the softness in world oil prices has resulted in a shortfall in revenues for this group of countries, restricting their ability to purchase foreign goods. (See *Delusive Trade Deficit*, ECONOMIC OUTLOOK, August/September 1984, and *The Mystery of the Dollar*, ECONOMIC OUTLOOK, April 1985).

We have consistently expressed our view that the dollar's strength derives from significant structural changes in the U.S. economy. Recent data from the Federal Reserve Bank of St. Louis adds strength to this viewpoint. In order to evaluate the significance of the dollar's strength, their report distinguishes between real and nominal exchange rate changes. A nominal exchange rate change balances differences in inflation between the U.S. and its trading partners. Changes in the real, or inflation-adjusted exchange rate, on the other hand, reflect changes in purchasing power resulting from structural changes such as relative price shifts, changes in tax laws or altered expectations about the future yield of assets. The data on the trade-weighted value of the dollar show a persistent exchange rate movement which more than offsets inflation differentials. The study concludes that the strength of the dollar follows from changes in the tax laws which have improved long-term prospects for the U.S. economy.

A comparison of bilateral trade between the U.S. and its major trading partners shows no clear pattern pointing to the acceleration in the value of the dollar as the real culprit. Since 1980, when the dollar began to appreciate, U.S. exports to the United Kingdom fell by four percent, to France and Italy by 20 percent, and to West Germany, by 17.3 percent. However, the decline in the value of their currencies with respect to the dollar bears no clear relationship. The pound sterling fell by 43 percent *vis-a-vis* the dollar between 1980 and 1984; the French franc and the Italian lira fell by 52 percent and 51 percent, respectively; and the German mark fell by 36.1 percent. During this same period, although the Canadian dollar fell by almost ten percent against the U.S. dollar, U.S. exports to Canada actually rose by 31 percent. Similarly, while the yen lost five percent of its value to the dollar, U.S. exports to Japan rose by almost 14 percent (see Table 1). France, Italy, and the United Kingdom, three countries with low-valued currencies, had trade deficits of $2.1 billion, $11.4 billion, and $6.3 billion, respectively, during the past twelve months.

American industry has become increasingly less competitive in world markets. Regardless of the measure used, whether relative costs, market shares, or productivity levels, the U.S. is still far less competitive today than at any time in the postwar period. The U.S. share of the global market has declined from 28 percent of adjusted total exports by major industrial countries in 1960, to 20 percent in 1972, remaining close to 20 percent since then. For purposes of comparison, the U.S. market share is now close to parity with that of West Germany, whose gross national product is approximately one-quarter the size of the U.S. The European Economic Community has also lost market shares – its percentage of total global exports fell from 48 percent in 1960 to 38 percent in 1983. Japan, not surprisingly, has emerged as the clear winner in the scramble for world markets, its share rose from five percent in 1960 to 13 percent in 1983.

TABLE 1
BILATERAL TRADE AND EXCHANGE RATES
(1980 to 1984)

U.S. Trade with:	Percent Change in Exports	Percent Change in Imports	Percent Change in Exchange Rate
United Kingdom	−3.9	+45.6	−42.6
France	−20.0	+51.8	−51.5
West Germany	−17.3	+44.7	−36.1
Italy	−20.0	+80.9	−51.3
Canada	+31.4	+59.3	− 9.7
Japan	+13.5	+83.0	− 5.0

One reason for this outcome is the decade-long slowdown in the rate of growth of U.S. labor productivity, which only recently began to reverse. Although the average productivity of American workers is still higher than that of workers in our major trading partners, and it has continued to rise, productivity in the rest of the world has nearly caught up by growing much more rapidly. Labor productivity in Japan has risen from 27 percent of U.S. productivity in 1960, to 72 percent in 1981; while the productivity of the European nations rose from 53 percent to 80 percent over the same period (see *The Productivity Challenge*, ECONOMIC OUTLOOK, April 1985). Relative costs of production also play an important role. Compared to Japan, the U.S. real after-tax cost of funds has typically been substantially higher. In 1984, Japan's total manufacturing costs were only 71 percent of those in the U.S.

This month's outlook shows an improvement in real exports as the dollar loses some of its strength and the recovery abroad continues. The trade-weighted exchange value of the dollar rises by 4.8 percent in 1985, compared to its average level in 1984, and then falls by 6.6 percent in 1986. However, the improvement in exports due to declines in the value of the dollar will not occur immediately since only about forty percent of the dollar's decline is reflected in contemporaneous improvements in exports. Industrial production in Japan, Canada, and

Europe is expected to continue strengthening, rising by 8.1 percent, 5.3 percent, and 4.4 percent, respectively, in 1986. This combination of a declining dollar and stronger growth abroad should raise the demand for U.S. goods and services, contributing to an 8.9 percent increase in real exports in 1986. The rise in real imports, on the other hand, should decelerate from 27 percent in 1984, to 6.2 percent in 1985 and 6.1 percent in 1986. The U.S. real trade balance on goods and services, which registered a surplus of $12.6 billion in 1983 and a deficit of $15 billion in 1984, deteriorates further to $24 billion in 1985, but improves to a deficit of $21.4 billion by 1986.

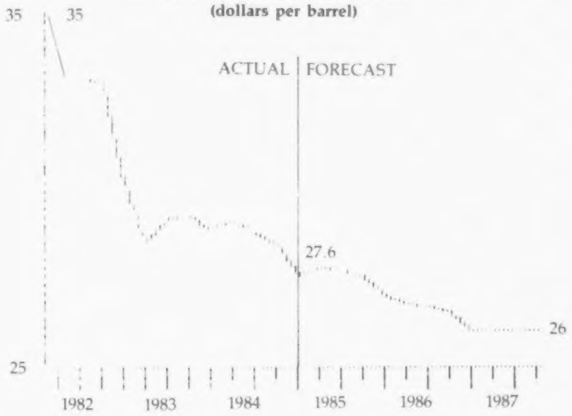
Prices, Wages and Productivity: No Inflationary Threat on the Horizon

Although recent declines in the value of the dollar, higher commodity prices, and the 5.3 percent increase in the implicit GNP deflator for the first quarter point to a slight worsening in inflation, there is little reason to worry about another price spiral. While a decline in the dollar's value will translate rather promptly into increased prices, as of early May the effective weighted-average exchange rate was still 11.9 percent above its year-ago level. Nevertheless, the rise in consumer prices in March, because it resulted from two categories of consumption which have a large import component, suggests that the slide in the value of the dollar may have begun to be felt in domestic price increases.

The recent drop in the value of the dollar led to a modest recovery in commodity prices, but only when compared to previously depressed levels. The *Journal of Commerce* spot commodity price index rose 1.4 percent in the four weeks ending March 29, with metals prices leading the way, however, they remain 8.4 percent below their year-ago level. Lumber prices, on the other hand, collapsed – the victim of excess capacity, a problem which continues to plague the industry.

After months of weakness, world oil prices began firming in February and March due to several factors. Among these are: (1) OPEC's apparently improved ability to control its own production levels; (2) extreme winter temperatures in Europe, which increased demand; and (3) large inventory requirements – end of year stocks in the OECD nations were at their lowest level in five years. Nevertheless, a continued erosion in the demand for oil, to the benefit of other fuels, has become increasingly apparent. World oil consumption grew by only one percent in 1984 despite the five percent surge in economic activity in the industrialized nations. While the short run outlook is for stability in crude oil prices, some factors argue for a price reduction in the longer term (see Chart 9). Significant among these is increased competition in world oil markets, both in production and refining of crude petroleum. Further, a substantial decline in the value of the dollar increases the likelihood of a dramatic break in prices. Because Middle-Eastern producers rely largely on the European nations as a source of imported goods, a fall in the value of the dollar would reduce their purchasing power, making it necessary for them to increase their exports, and hence, their production of crude, in order to earn the additional foreign exchange with which to pay for imports. This increase in production would raise the available supply, placing downward pressure on prices.

CHART 9
AVERAGE REFINERS' ACQUISITION PRICE
FOR IMPORTED CRUDE OIL
(dollars per barrel)



The sharp rise in the first quarter's GNP deflators should be discounted because it reflects changes in the mix of GNP and federal pay increases. A surge in the consumption of energy early in the quarter accounts for the discrepancy between the implicit and fixed-weight deflators. Since 1972, energy price deflators have increased more than others. Therefore, a shift towards high-priced energy purchases would lead to an increase in the value of the implicit deflator. The increase in the fixed-weight deflator, on the other hand, was entirely due to the federal pay increase. If this sharp rise in the GNP deflators is an indication of sustained inflationary pressures, we would expect to see corresponding increases in producer and consumer prices. However, while consumer prices rose in March, the rise did not reflect an across-the-board acceleration. Excluding the increase in energy prices, the consumer price index rose by only 0.3 percent. Producer prices rose by 0.2 percent, following a 0.1 percent decline in February. This trend continues the up/down pattern which has kept producer prices in a plateau for the last year.

On the wage front, several factors argue for continued moderate increases in wages. Private sector compensation rose by 4.4 percent in March compared to its year-ago level, the smallest increase since 1979. Included among the factors which will restrain the growth in wages are an increase in competition from three sources: (1) nonunion competition has intensified; (2) deregulation of certain key industries has increased competition in domestic labor markets; and (3) foreign competition continues strong. Also, in spite of a dramatically improved employment

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS									YEARS		
	Actual		Forecast							Actual	Forecast	
	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	4.3	1.3	4.5	4.4	3.9	4.7	4.2	4.4	4.5	6.8	3.5	4.3
Consumption	3.6	4.7	4.0	3.6	3.9	4.1	3.4	3.4	3.6	5.3	3.9	3.8
Residential Investment	-5.9	-0.7	7.2	19.1	2.1	4.6	8.2	8.9	9.9	12.2	1.9	7.5
Business Fixed Investment	8.5	3.4	9.0	7.8	10.3	12.0	12.4	11.2	12.5	19.8	8.7	11.0
Equipment	5.4	-1.2	8.8	9.1	12.0	14.1	14.5	13.6	13.7	21.5	7.6	12.8
Structures	17.2	16.2	9.4	4.7	6.0	6.8	7.1	5.1	9.3	15.6	11.4	6.5
Exports	-0.8	-8.2	4.6	5.1	10.5	10.1	9.3	9.6	9.4	4.7	0.7	8.9
Imports	-28.3	26.2	-3.2	6.2	7.1	8.0	6.5	4.8	6.6	27.0	6.2	6.1
Government Purchases	5.9	0.1	4.7	3.0	-3.6	0.5	0.3	0.6	1.0	3.5	3.9	0.3
Inventory Change ($B)	37	47	39	38	42	43	42	42	40	58	41	42
New Car Sales (mil. units)	10.3	10.8	10.8	10.9	11.1	11.2	11.3	11.6	11.8	10.4	10.9	11.5
Housing Starts (mil. units)	1.6	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.1	1.8	1.8	2.0
EMPLOYMENT, WAGES AND PRICES												
Unemployment Rate (%)	7.2	7.3	7.2	7.1	7.0	6.9	6.7	6.6	6.5	7.5	7.2	6.7
Compensation	3.6	10.4	3.9	4.4	4.7	6.3	5.4	5.7	5.9	4.2	5.6	5.6
Productivity	2.3	-1.5	2.6	2.3	2.9	2.5	2.4	2.6	2.8	2:7	1.4	2.6
Unit Labor Costs	1.3	7.5	1.3	2.1	1.8	3.7	3.0	3.0	3.2	1.4	4.2	3.0
Consumer Prices	3.5	3.3	3.6	3.4	3.6	3.8	3.8	3.8	4.0	4.3	3.5	3.7
GNP Deflator	2.8	5.3	2.9	2.6	3.3	3.5	3.6	3.8	4.3	3.8	3.6	3.4
Prime Interest Rate (%)	11.8	10.5	10.3	10.0	9.8	9.3	9.1	8.6	8.4	12.0	10.2	8.8
Profits from Current Production ($B)*	203.9	209.8	220.8	225.2	230.0	233.2	239.8	244.6	247.6	195.9	221.5	241.3
GOVERNMENT FISCAL POLICY ($BILLION)**												
Unified Budget – Receipts										666	740	794
Unified Budget – Outlays										842	954	972
Unified Budget – Federal Surplus or Deficit										-176	-214	-178

*Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

SOURCE: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's first estimates of the National Income and Product Accounts for the first quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government spending of $40 billion in fiscal 1986. Government spending, on an NIA basis, grows at an average annual rate of three percent between 1985 and 1987. The nation's money supply, as measured by M(1), is anticipated to grow by 6.6 percent in 1985 and 6.4 percent in 1986. The federal minimum wage remains at $3.35 an hour throughout the forecast interval. Due to inventory requirements, the average price of imported crude oil strengthens slightly in the near term; it remains at $27.70 in 1985, but fails to $26.79 in 1986. The trade-weighted exchange value of the dollar rises by 4.8 percent in 1985 compared to the average 1984 rate, but depreciates by 6.6 percent in 1986.

situation due to the economy's continued ability to create new jobs, the civilian unemployment rate remains high as the labor force continues to swell. This will also maintain downward pressure on increases in wages.

Nonfarm business sector productivity decreased at an annual rate of 1.5 percent in the first quarter. However, output per hour in the manufacturing sector rose by 1.7 percent on the strength of a 3.1 percent advance in productivity in the durable goods sector. First quarter unit labor costs rose by 7.5 percent in the nonfarm business sector as increases in compensation outstripped productivity gains. However, the 10.4 percent surge in employee compensation was associated with the January 1st increase in employer contributions to Social Security. For an in-depth discussion of the productivity issue, see last month's ECONOMIC OUTLOOK.

Federal Budget

This month's outlook assumes that efforts to reduce federal spending meet with only partial success. The static reduction in federal outlays amounts to $40 billion in 1986 compared to $52 billion in the White House/Republican Leadership compromise budget plan. Real economic growth is anticipated to remain relatively strong, rising by 3.5 percent in 1985, and 4.3 percent in 1986. This leads to a real increase in investment for producers' durable equipment of 22.4 percent by the end of 1986 compared to the actual (first quarter) level. Rising levels of investment spur growth in labor productivity, which is expected to rise by 2.6 percent in 1986. As a result, the civilian unemployment rate falls to 6.7 percent in 1986 as 4.4 million new civilian jobs are created. Inflationary pressures remain moderate, the consumer price index rises by 3.5 percent in 1985 and 3.7 percent in 1986, compared to 4.3 percent in 1984. The prime interest rate trends down, averaging 10.2 percent in 1985 and 8.8 percent in 1986. The unified federal deficit reaches $214 billion in fiscal year 1985, but falls to $178 billion in fiscal year 1986.

Conclusion

In closing, we would like to remind the reader that a forecast is only as good as the data on which it is based. In this regard, recent analyses have called into question the reliability of official data as accurate measures of economic activity. Problems exist with the calculation of two measures of prices which feed into the real GNP data. Experts in business cycle research have noted that the treatment of the implicit deflator for imports causes an understatement of real GNP, which amounted to as much as one percentage point during each of the past several quarters. Moreover, a recent report by the Council of Economic Advisers (CEA) points to serious measurement errors in real GNP, which arise out of the way in which the government calculates the price of computers in assessing their contribution to total production.

Currently, these calculations are made under the assumption that the price of computers remained unchanged over the years, and that any increases in prices were matched by the cost of quality improvements, thereby yielding no change in real costs. However, this assumption has not held true. Since the late 1970s, manufacturers have consistently introduced new computer models which were both lower priced and of a substantially improved quality. While this was not a major issue in 1975 when computers were a very small proportion of overall production, their importance has since risen significantly. Purchases of computing equipment reached $17 billion in 1982, the equivalent of eight percent of purchases of producers' durable equipment. A measure of the importance of this erroneous assumption is contained in the CEA report, which states that in each of the last three years, reported real GNP growth would have been more than one percentage point higher had computers been properly taken into account. Unfortunately, the problems do not stop at measured GNP. This error also raises questions regarding the reliability of other indicators of economic health. The error in the reporting of GNP feeds through to other statistics, such as productivity, the producer price index, industrial production and retail sales.

THE ECONOMIC IMPACT OF THE WHITE HOUSE/REPUBLICAN LEADERSHIP COMPROMISE BUDGET PACKAGE

by

Graciela Testa-Ortiz

While we expect that the economy will continue on a path of relatively stable, noninflationary growth, this forecast could partially depend upon the outcome of budget deliberations now taking place in the Congress. Budgetary deadlock, followed by a tax increase as an attempt to cover the deficit, could lead to a very dismal outlook for the nation's economy.

Data Resources, Inc. (DRI) has recently developed several simulations of how the economy might fare under different fiscal outcomes. Under one such scenario, the recent declines in interest rates, coupled with the rise in consumer confidence which has also become evident, contribute to strong economic growth during the remainder of this year. However, as we near 1986, according to DRI, Congress' failure to enact a new budget which effectively addresses the problem of soaring federal spending growth, significantly reduces business and consumer confidence. At the same time, strong growth in 1985 increases credit demands, which because they are not satisfied through monetary ease, result in rising interest rates, pushing the economy into recession by the second quarter of 1986.

In this DRI scenario, the recession lasts through the end of 1986, with real GNP falling by 1.7 percent from the economy's peak in the first quarter of 1986, to its trough in the last quarter of 1986. Total automobile sales (domestic and imports) fall to a low of 9.1 million units, although total consumption drops modestly. Nonresidential investment declines by 7.5 percent, and new housing starts drop by 516,000 units as mortgage interest rates reach 14.24 percent in 1986. Total nonfarm employment falls by 1.39 million jobs, and the civilian unemployment rate reaches a peak of 8.95 percent. Towards the end of 1986, looser monetary policy and lower interest rates contribute to a recovery beginning in 1987.

DRI has also performed an econometric simulation of the impact of the White House/Republican Leadership compromise budget plan, which includes the spending reductions called for in that package. In addition, in keeping with Federal Reserve Board Chairman Paul Volcker's statements that monetary policy can only be eased once something is done about the federal deficit, this simulation assumes that he keeps his word. The nation's money supply, as measured by M(1), grows by 6.4 percent in 1986 and 5.9 percent in 1987, compared to 5.4 percent and 5.7 percent, respectively, in the recession scenario.

A comparison of these two scenarios makes a dramatic case in support of the compromise budget plan (see Table 1). According to DRI, enactment of the budget plan would result in the following:

- Real gross national product rises by $13.4 billion in 1986 and $59.4 billion in 1987.
- Real consumer spending increases by $3.2 billion in 1986 and $20.8 billion in 1987.
- Real nonresidential investment rises by $1.2 billion in 1986 and $30.4 billion in 1987. A large part of the increase in nonresidential investment is in productivity-enhancing producers' durable equipment, which rises by $0.7 billion in 1986 and $21.6 billion in 1987. Investment in nonresidential structures rises by $0.5 billion and $8.8 billion, respectively.
- Real residential investment also benefits, rising by $8.2 billion in 1986 and $10.1 billion in 1987. New housing starts increase by 415,000 units in 1986 and 195,000 units in 1987.
- Real exports of goods and services rise by $0.9 billion in 1986 and $7.5 billion in 1987, while real imports of goods and services decline by $1 billion in 1986, but rise by $5.3 billion in 1987. This results in an improvement in real net exports of goods and services of $1.9 billion in 1986 and $2.2 billion in 1987. By the end of 1987, the U.S. dollar has fallen in value by 20 percent relative to its current level.

TABLE 1
ECONOMIC IMPACT OF THE COMPROMISE BUDGET PLAN

(difference from recession scenario in billions of 1972 dollars, unless otherwise indicated.)

	1986	1987
Gross National Product (a)		
Real GNP	$13.4	$59.4
Consumer Spending	$3.2	$20.8
Nonresidential Investment	$1.2	$30.4
Equipment	$0.7	$21.6
Structures	$0.5	$8.8
Residential Investment	$8.2	$10.1
Housing Starts (b)	415,000	195,000
Exports	$0.9	$7.5
Imports	($1.0)	$5.3
Real Net Exports of Goods and Services	$1.9	2.2
Federal Government Purchases	($5.2)	($11.3)
EMPLOYMENT, WAGES AND PRODUCTIVITY (c)		
Nonfarm Employment (d)	90,000	314,000
Unemployment Rate (e)	-0.15	-1.3
Consumer Price Index	-0.7	0.0
Implicit GNP Deflator	-1.0	-0.5
Average Hourly Earnings	-1.1	0.4
Compensation	-0.9	0.6
Labor Productivity	0.2	0.8
Unit Labor Costs	-1.1	-0.3
INTEREST RATES (f) AND THE DEFICIT (g)		
Prime Rate	-437	-224
Federal Funds Rate	-497	-258
3-month Treasury bill Rate	-441	-234
AAA Corporate Bond Rate	-165	-239
Mortgage Rate (h)	-186	-219
Unified Receipts	-8.6	18.0
Unified Outlays	-74.8	-138.8
Unified Deficit	-66.2	-156.8

(a) Parentheses indicate negative values.
(b) Increase in housing starts relative to recession scenario.
(c) Percentage point difference in growth rates relative to recession scenario, unless otherwise indicated.
(d) Increase in number of jobs relative to recession scenario.
(e) Percentage point difference in unemployment rate relative to recession scenario.
(f) Basis points difference relative to recession scenario.
(g) Difference relative to recession scenario in billions of current dollars.
(h) 25 year mortgage, 75 percent loan.

Source: Data Resources, Inc. The recession alternative is LATERECESS0585. The simulation of the White House/Republican Leadership compromise budget plan is NEWBGTACC0585.

- Nonfarm employment increases by 90,000 in 1986 and 314,000 in 1987, and the civilian unemployment rate falls by 0.15 percentage points in 1986 and 1.3 percentage points in 1987.
- Measures of prices, wages and productivity improve as a result of the enactment of the budget compromise plan. Growth in the consumer price index falls by 0.7 percentage points in 1986, while the rate of increase in the implicit GNP deflator declines by one percentage point in 1986 and 0.5 percentage points in 1987. The rate of growth in average hourly earnings falls by 1.1 percentage points in 1986, but rises by 0.4 percentage points in 1987. Growth in labor productivity rises by 0.2 percentage points in 1986 and 0.8 percentage points in 1987. Consequently, growth in unit labor costs decelerates by 1.1 percentage points in 1986 and 0.3 percentage points in 1987.
- These improvements in the nation's economy come about, in large part, as a result of substantial declines in interest rates as federal credit demands ease. The prime interest rate falls by 437 basis points in 1986 and 224 basis points in 1987. The decline in other interest rates is detailed in Table 1.
- The compromise budget package leads to large declines in the unified federal budget deficit. On a calendar year basis, the unified deficit falls by $66.2 billion in 1986 and $156.8 billion in 1987, largely as a result of declines in federal outlays which fall by $74.8 billion in 1986 and $138.8 billion in 1987 (these are dynamic, not static, changes in outlays). If the budget plan is enacted, the NIA deficit falls to 3.1 percent of GNP by 1987, compared to 6.7 percent under the recession scenario.
- In terms of government share of GNP, the enactment of the compromise budget plan would reduce government outlays to 22.7 percent by 1987. In contrast, under the recession scenario, government spending as a percent of GNP would continue rising, from 24.4 percent in 1985 to 26.2 percent by 1987.
- The compromise budget plan shifts the composition of real GNP away from consumption, which falls from 65.3 percent of GNP in 1985 to 65 percent by 1987, compared to an increase in this ratio to 66 percent under the recession scenario. Nonresidential investment rises to almost 14 percent of GNP by 1987, compared to 13 percent in 1985. Under the recession alternative, nonresidential investment would only amount to 12.6 percent of GNP by 1987. The continued improvements in investment, which began in 1981 with the enactment of the Economic Recovery Tax Act, help to enhance the long-run potential of the U.S. economy by creating new jobs, improving the international competitiveness of U.S. firms, raising labor productivity, and ultimately, providing an improved standard of living for all Americans.

FEDERAL BUDGET FOLLIES

by
William Orzechowski

Nearly everyone agrees that federal spending is out of control, but few members of the public fully appreciate the many absurdities that arise when government spending programs encroach upon so much of the American economy. More often than not, average and below average income workers must pay heavy tax burdens to subsidize individuals who have incomes that greatly exceed their own. Moreover, these subsidies many times go for programs that should have never existed in the first place. In other cases, the federal budget is simply a device to shuffle money so that individuals in one location subsidize those in another location when, in fact, there is no rationale for any subsidy in the first place. What follows are some examples of these distortions.

Farm price support subsidies have to rank at the top in terms of fiscal perversity. The average hard working factory worker earns about $17,500 a year. He will pay approximately $3,300 in total taxes to the federal government, of which $66 go to support $15 billion of price support subsidies in 1985. Nearly 40 percent of this subsidy, or $6 billion, goes to the largest ten percent of farms, translating into a subsidy of, at least, $16,000 for each. Net income for this group averages a whopping $84,000 per year. Further, the average equity position of the top 29 percent of all farms is about $800,000. In essence, our hard working factory worker is paying $66 so that farmers, with much greater assets and income, can receive a $16,000 annual subsidy.

Unfortunately, this is not the end of the farm story. What does our average factory worker get for his $66 contribution to farmers? He gets to pay higher food prices. For example, the federal price support program means that he has the privilege of paying more than double the world price for dairy products and over four times the world price for sugar.

Let's take the case of an average service worker in Philadelphia, who commutes to work each day on Philadelphia's subway system, which was built at the turn of the century. He will pay seven cents of his income in federal taxes this year so that residents of the Washington, D.C. metropolitan area can receive a $250 million grant to finish building their new, posh subway system. In essence, the Philadelphia service worker, who earns $11,000 a year, is making it possible for Washington's commuters to receive a $200 per capita subsidy to finish their transit system. However, the average income of Washington commuters exceeds $20,000 a year. Why should those who sit in Philadelphia's trolley cars pay seven cents of their income so that relatively affluent Washingtonians can ride in their sleek Metro?

One of the greatest distortions involves Social Security. This program pits today's workers against those who are retired and those approaching retirement. The average worker below age 44 pays about $1,500 per year in Social Security taxes. This goes to the typical retiree who collects almost $5,338 annually in Social Security benefits. Yet, the per capita income of an elderly household is greater than that of a non-elderly household ($9,080 versus $8,960). Furthermore, the typical retiree owns many more assets and pays less taxes than our young worker. However, the kicker is that the relatively affluent retiree is being subsidized at a phenomenal rate on his Social Security benefits. As unbelievable as it sounds, the typical retiree will receive real lifetime Social Security benefits of about $95,000, but his payments and those of his employer, including the value of interest over the period, add up to a mere $30,000. In effect, over his lifetime, the retiree will receive benefits which greatly exceed the value of his total contribution. In spite of all this, most Social Security recipients live under the illusion that they have *paid* for their benefits, and there are a host of politicians willing to perpetuate this notion.

Today's young workers will not fare so well. By the time they retire, simple demographics will force them to receive a much lower return on their rising payroll taxes.

In 1986, about $8 billion in federally subsidized loans and grants will be granted to college students. Aid available from federal and state sources amounts to about $1,000 per year for every college student in America. Unfortunately, a good portion of such aid goes to students whose parents' income substantially exceeds the national average, since 25 percent of all college freshmen receiving federal aid are from families in the upper half of the income distribution.

Let's take the case of a hard working factory worker who never went to college. Of the $3,300 he pays in federal taxes per year, $35 will go to support student loan programs. About $5 of this will go to families with almost double his income. This will make it possible for the relatively rich family to receive a $3,000 subsidy in the form of guaranteed student loans (GSL) for their children who attend college ($3,000 is the subsidy value for four years of GSLs). After college these individuals will go on to receive a much higher income than our factory worker.

The Civil Service Retirement System is a classic federal boondoggle. Our average factory worker shells out $105 of his $3,300 in federal taxes to subsidize the pensions of highly paid federal workers which, on average, will be over double the average private sector pension. Federal employees pay only 20 percent of the cost of their retirement benefits; the taxpayer is stuck with the remaining 80 percent. An average federal retiree with a final salary of $25,000 will receive about $542,000 in lifetime benefits. A private sector worker with the same salary will get about $266,000 in lifetime benefits. A federal retiree with a final salary of $50,000 will receive a lifetime benefit of $1,085,000, compared to $398,000 for his private sector counterpart. Even more galling is the fact that the private sector worker will be toiling at his job until he reaches his sixties, while the federal worker can retire as early as age 55.

The Rural Electrification Administration (REA) makes loans to rural electric co-ops at the bargain rate of five percent. Until 1973, it made those loans at two percent. Between 1973 and 1983, the value of below market loan subsidies to co-ops for the life of the loan is conservatively estimated at $33 billion. The purpose of these loans is to make electricity available to rural America. However, the taxpayer would become electrified if he knew that 98 percent of rural America had already received electricity by 1954! Instead, this boondoggle program continues merely to make electricity rates lower, on average, by 12 percent for co-op customers, while the rest of us fork up tax dollars to keep the subsidies going. What do we get for this? A system bordering on default that led to a bill in Congress—S.1300—that would essentially forgive many of the subsidized loans owed by the REA to the U.S. Treasury.

The Amtrak gravy train has been rumbling along for many years. What the public does not know, however, is the monumental costs needed to keep the system going. Revenues cover only 58 percent of operating costs, and they do not even begin to cover fixed costs—depreciation, taxes, interest, and labor protection. System-wide, the average subsidy per passenger is $35. On some routes (New York-Boston, Chicago-New York, Portland-Seattle) the subsidy is so large that it would be cheaper to sidetrack the trains and buy all the existing passengers *bus or plane tickets.* The Amtrak corporation negotiated a labor agreement providing up to six years full salary for employees who are furloughed. The liability for this stands at $2.1 billion. If Amtrak goes bankrupt due to subsidy termination, the government's claim on assets could be easily relinquished to allow for payment of labor protection benefits, leaving the poor taxpayer to wait in line.

The Job Corps is the highest cost training program in the federal budget. Each one of the Job Corps 40,500 slots will cost the taxpayer $15,200. The cost to the taxpayer equals the cost of a Harvard education, and is three times the annual cost of an education at the average four-year public university. Only one-third of Job Corps terminees are reported as employed within the year they leave the Job Corps. The Job Corps is considered only marginally better than the Comprehensive Employment Training Administration (CETA), which, generally recognized as a failure, was terminated with bipartisan support.

The new elevated rapid transit system in Miami was a one billion dollar mistake. Ridership on the system is only about 10,000 per day—ten percent of what was originally forecast. It would have been cheaper to give each rider $100,000! Most federally-funded systems cost between $50 million and $100 million per mile. The San Diego light rail system, completed without any federal subsidies, cost only $6 million per mile. From 1970 to 1980, the use of public transit decreased from 8.9 percent to 6.4 percent of total work trips taken, yet federal support grew by 2,150 percent. Rarely have so many paid for the benefit of so few. Over the past ten years, mass transit costs have gone up 80 percent while fares have gone up by only 30 percent, causing a rising subsidy rate over time.

Worse, Federal subsidies, in many cases, benefit the middle and upper income riders and not the needy as is the case of the Washington Metro, 71 percent of whose riders have annual incomes of over $20,000.

The cases above are only a small sample of the fiscal distortions that exist in the federal budget. A much larger sample is contained in the Office of Management and Budget (OMB) list of potential budget cuts for 1986 and beyond. OMB director David Stockman's comprehensive study, *Background on Spending Reforms in the FY 1986 Budget*, is a monumental testament to the blatant extravagance found within the federal budget. Hopefully, his study will be the blueprint for a serious effort to curtail the growth of federal spending.

WHEN WILL THE LIGHTS GO OUT?

by

Rajri Bonnie Ohri

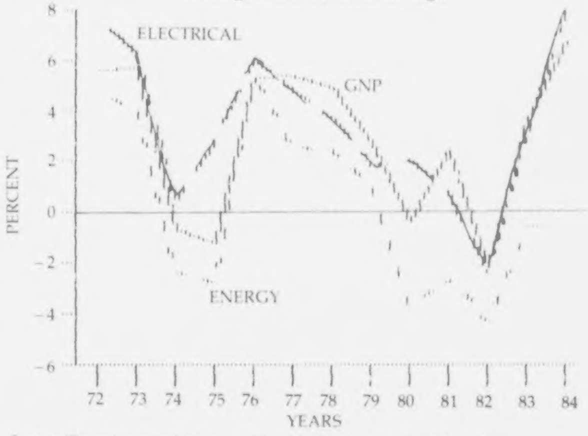
Before the end of the decade, in parts of the U.S., particularly the Northeast, the term 'electricity crisis' could very likely become as familiar as the term 'energy crisis' was in the 1970s. Currently, concern is being voiced among many forecasters in the electric utility industry that the U.S. could witness an electricity shortage by the 1990s. But others question this. Many industry officials are certain that no utility capacity shortage exists now or is likely to exist in the foreseeable future. The unexpected spurt in nationwide electricity usage in 1984, following several years of low growth, has added fuel to a growing debate over how to meet future electricity demand.

The combination of a revived economy and extreme weather resulted in the surprising 8.3 percent rise in electricity production in 1984, the highest annual increase since 1973. Industry officials acknowledge that the strong increase followed unusually depressed figures for 1982 and early 1983, when mild weather and recession so depressed electricity demand that production in 1982 actually fell by 2.4 percent, the first annual decline in the industry's history. Over the past two decades, regulators and forecasters in the electric utility industry have consistently overestimated electricity demand. Expectations that power use would continue doubling every ten years, as it had in the 1950s and 1960s, led to an ordering binge for nuclear plants that turned into a flood of cancellations when economic growth, and thus, electricity demand fell in the late 1970s. Now, a new set of high-growth forecasters are predicting that another wave of heavy investment in electric generating plants, coal as well as nuclear, are necessary if an electricity crisis is to be averted by the end of the decade. They see electricity consumption growing in the four percent to five percent range. Others, questioning this assumption, predict growth in demand between zero and two percent a year throughout the rest of the decade.

Electric Utilities in the 1970s

During the 1970s, inconsistent economic policies, combined with sharp increases in the world price of oil, contributed significantly to inflation and lower economic growth in the U.S. But, throughout that period, electric generation out-performed both real economic growth and total energy growth (see Chart 1). Between 1973 and 1981, the real increase in the weighted price of energy was about 160 percent, while the real price of electricity increased by only 50 percent. Recessions in 1974-75 and 1980-81 held average economic growth between 1972 and 1981 to an annual rate of 2.7 percent. During the same period, total energy growth averaged about one percent while electricity production grew by three percent per year.

CHART 1
ENERGY AND ELECTRICAL GROWTH
(Average Annual Percent Change)



Source: Department of Energy, *Monthly Energy Review*, Statistical Abstract of the United States 1985.

Spurred by declining prices, electricity demand during the 1970s grew faster than gross national product (GNP), and public utility commissions were able to lower rates while keeping utility profits healthy. Encouraged by yearly growth rates as high as seven percent to ten percent in the early 1970s, and by the lure of cheaper electricity expected by a new generation of nuclear power plants, utilities undertook massive building programs. The energy crisis also led them to believe that additional growth would stem from residential and industrial customers cut off from natural gas or eager to find a substitute for imported oil. Ever cheaper electricity was packed into everything, from home appliances to street lighting and industrial processes.

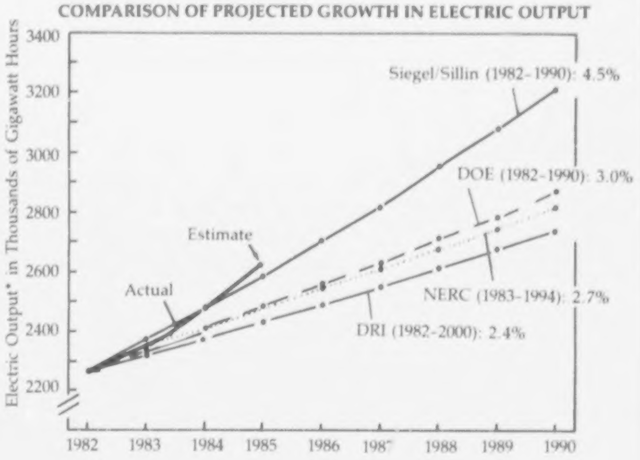
However, after 1974, rising fuel and construction costs pushed up real power prices faster than GNP. The economies of scale within the industry abruptly vanished as large new plants no longer meant gains in economic efficiency. In addition, concern over the environmental impact of conventional power plants increased, as did opposition to nuclear plants. This concern reached a fevered pitch in 1979 following the Three Mile Island incident. Since 1975, 85 planned nuclear generating plants have been abandoned at a cost of over $16 billion. Further, as electricity prices began to rise, demand growth slackened. In fact, the demand for power proved surprisingly price-elastic – meaning that when rates went up electricity demand fell. That, in turn, led to severe financial problems for the industry and cancellations of planned power plants.

A near tripling of world oil prices in 1979-80 contributed, once again, to higher commodity prices, inflation, and a sharp downturn in economic activity. In 1980-81, economic growth averaged under one percent and total energy usage fell by 2.8 percent. Nevertheless, as in 1974-75, electric generation grew at a faster rate than economic activity and overall energy consumption. Throughout the remainder of the 1980s, real economic growth is expected to average four percent per year. If current economic conditions are sustained, electric load growth could increase above the three percent average of the 1973-81 period. Further, electricity is in a better price position relative to oil and natural gas than at any point in the last twenty years. This should enable electricity to penetrate the industrial and home heating markets which have been dominated by oil and natural gas since the 1950s.

Are Utilities Underforecasting?

Due to the sudden surge in electricity demand after years of low growth, uncertainty exists among utility forecasters regarding future growth (see Chart 2). Questioning the potential for faster economic growth, some utility forecasters have continued to reduce their projections. For example, the North American Electric Reliability Council (NERC), the official forecasting organ for the utility industry, issued a recent demand growth forecast of 2.7 percent per year from 1982 to 1990, which is lower than the Department of Energy's (DOE) projection of three percent per year. Among the utilities, the Edison Electric Institute (EEI) forecasts an average annual electricity growth rate of 2.5 percent for the rest of the decade; Commonwealth Edison recently lowered its official electricity forecast from three percent to two percent per year; and New England and Middle Atlantic utilities generally show electric growth projections of no more than one percent per year. While the faster growing Sunbelt regions are projecting more rapid rates of electricity growth than the rest of the country, the general forecasted increases in electricity have been significantly scaled back from earlier estimates.

CHART 2
COMPARISON OF PROJECTED GROWTH IN ELECTRIC OUTPUT



*Electric Output: Total electricity made available for consumption; for EEI "Total Source," Quarterly Report.

NOTE: Due to difficulties in identifying the first forecast year of each projection, and the fact that some projections are changed on an annual basis, 1982 was assumed to be the base year. Exceptions: NERC, whose base year was determined to be 1983; 1985 point is an estimate and assumes 6% growth.

Source. "Rethinking Utility Strategy under Conditions of High Growth," John Siegel and John Sillin, *Public Utilities Fortnightly*, September 13, 1984.

Data Resources, Inc. (DRI), projects modest electrical growth over the near-term. Increasing demand for electricity, albeit at a slower rate than that experienced in 1984, combined with weaker fuel prices, will result in an improved financial health for the electric utility industry. During the period 1982 to 2000, DRI forecasts a 2.4 percent rate of growth in electric output. According to Wharton Econometric Forecasting Associates, overall growth in electricity demand will barely reach three percent for the rest of the decade because cyclical industries such as metals, chemicals, paper, oil refining and cement, which account for over half of industrial power use, are expected to be in a downswing.

But, given the potential for sustained improvements in economic and financial conditions, why are electric load growth projections continuing to decline? For example, assuming an economic expansion consistent with our high growth scenario (see ECONOMIC OUTLOOK *Masters of our Destiny? Why Sustained Economic Growth is Possible*, October 1984), and a continuation of the historical relationship between economic growth and electrical demand, high growth forecasters John Sillin and John

Siegel, calculate a rate of growth in demand which greatly exceeds all current projections. They claim that the low growth bias in utility load planning generally occurs because of the following: a pessimistic view of regional and overall economic growth rates; little or no acknowledgement of the potential cross-elasticity effects resulting from the run-up in oil and natural gas prices; and an overestimate of the benefits of conservation and load management.

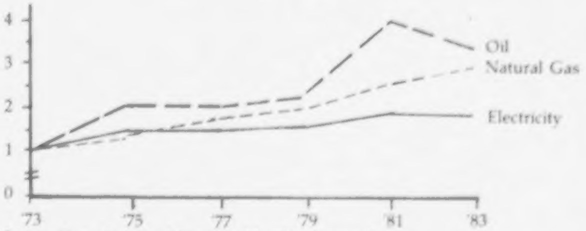
High growth forecasters predict demand for electricity will grow by four percent to five percent a year throughout the end of the decade – nearly double the industry's projections – leading to possible shortages of electricity supply by the 1990s. For example, if current trends continue through 1985, electricity sales in New York and New England will have increased by 15 percent since 1982, or nearly five percent a year. This compares with projections made in 1983 by regulatory and utility concerns which foresaw annual increases of only 1.8 percent for the same period. This high electricity demand during the 1980s is based on strong rates of economic growth and electricity's dramatically improved competitiveness, i.e., falling real electric prices and favorable demographic trends. The implications for our economy as a whole are significant. If higher electric growth is sustained, new plant and equipment commitments of at least $1.5 trillion to $2 trillion are required over the next ten years.

The High Growth Scenario

High demand for electricity in the 1980s is based on improved economic growth and market forces associated with electricity's dramatically improved price position relative to oil and natural gas. Sustained economic growth, averaging 3.5 percent to 4.5 percent per year versus the 2.2 percent of the 1973-82 period, is predicated upon the success of the Administration's economic policies – consistent monetary policies, lower tax and regulatory burdens, which encourage incentives to save and invest in new capital stock; stable or falling energy prices; increased productivity; and real income growth.

Electricity's greatly improved price position compared with oil and natural gas, and the likelihood that this will continue, is another reason that electricity demand will rise dramatically. Since 1973, electricity has improved its price position *vis-a-vis* oil and gas by 150 percent (see Chart 3). Consumers in New England, for example, paid the same real price for electricity in 1984 as they did in 1974. During the same period, however, real prices for heating oil and natural gas increased regionally by 40 percent and 100 percent, respectively. The nationwide 22 percent gain in electricity use since 1973, and 18 percent drop in gas and oil use enabled electricity to lift its domestic energy market share to 37 percent from 27 percent. Before 1973, electricity's penetration rate in the new home heating market was thirty percent nationally. Following the 1973 run-up in oil prices, it jumped to fifty percent. Recently, that rate hit nearly seventy percent. As electricity becomes more price competitive *vis-a-vis* other sources of energy, the demand for it rises at the expense of those other sources, namely oil and gas. This so-called cross-elasticity effect more than offsets declines in demand due to any increases in the price of electricity. In effect, higher rates of electric growth, which lead to lower production costs, coupled with stable fuel prices should assure that real prices decline over the long term.

CHART 3
INDEX OF REAL ENERGY PRICES
(1973 = 1.0)



Source: Department of Energy, *Monthly Energy Review.*

Most high growth forecasters also assume that electricity usage moves in lockstep with GNP. The relationship between electric growth and GNP appears to be a nonlinear function of the magnitude of GNP – increasing with increasing levels of GNP. Between 1960 and 1972, when GNP growth averaged four percent, electricity growth was double that of GNP; between 1973 and 1982, when GNP growth averaged 2.2 percent, electricity growth averaged 2.5 percent, or about 1.1 times GNP growth. This has been the case over the last thirty years and appears to reflect increasing levels of new plant and equipment expenditures, a precursor of increased productivity and income. In periods of sustained economic growth, investment rates in new plant and equipment accelerate, resulting in a substitution of capital for labor, and increased energy usage. Further, in an improved economy, rising real income results in higher energy usage due to income elasticity effects. For example, from 1960 to 1972, real personal income grew by more than thirty percent. Each percentage point rise in real income is estimated to result in a similar increase in electricity use. However, from 1973 to 1982, real income increased by only five percent. In that period, the annual increase in capital spending averaged 1.1 percent, compared with an annual rate of 4.4 percent from 1960 to 1972.

Upturns in the ratio of electric load growth to GNP appear to lag new plant and equipment expenditures trends by about two years, which, in turn, lag economic upturns by 12 to 18 months. Thus, the current recovery could contribute to a further increase in the electricity demand to GNP growth rate ratio by 1986-87. In the 1980s, more favorable financial markets, incentives to invest and a labor force growing at one-third the rate of the past ten years, should accelerate capital investment, productivity, real income and electricity usage.

Fueling the Debate

The electric utility industry is clearly divided between high growth forecasts that predict a looming electricity crisis versus low growth forecasts that claim that the power shortage is a mirage. Low growth utility forecasters point to the fact that national averages indicate that the U.S. has substantial extra electricity capacity. Since the U.S. currently has a 40 percent reserve margin (20 percent is the minimum acceptable level), it will take at least eight years to use up our present excess capacity. But, these averages disguise wide regional disparities, and no 'national grid' yet exists to adequately link the supply-poor and supply-rich regions. At greatest risk is the rapidly growing Sun Belt. Indeed, if electricity demand grows at only two percent a year, DOE forecasts serious supply shortages in Kansas, Arkansas, Louisiana, Texas, California and parts of Missouri and Mississippi by the early 1990s. Also at risk are five Frost Belt states: Iowa, Minnesota, Nebraska, and North and South Dakota. In addition, as described in recent news reports, at its present rate of growth, Long Island, New York, may be just a year away from power disruptions. Nevertheless, the New York State Energy Department insists that the Shoreham nuclear plant is not needed.

In response to those forecasters who predict high growth in electric demand, many utilities have indicated that if shortages do occur, they will rely on a strategy of importing excess power from other regions. Given an outlook for higher growth, there are several reasons why the industry should question this strategy. First, it should be remembered that bulk power sales are usually for limited periods of time and generally give the seller the option to renegotiate should growth exceed expectations. Thus, power purchase agreements are typically directed towards addressing short-term capacity needs, but should not be excessively relied upon for the longer term. Second, it is not clear how much power will be available if importing turns out to be everyone's fallback strategy. For example, many east coast utilities indicate that they plan to purchase coal-fired power from the Midwest, thus eliminating the need to build additional capacity. But this strategy will not be viable if several utilities rely upon it at the same time. The same holds regarding proposed power purchases from Canada. The Northeast could import electricity from Canada, which has a surplus of power from its hydroelectric project in the James Bay. But the bulk of this power is sold on an 'interruptable' basis, meaning that the Canadian utilities have the right to cut off exports if the power is needed for domestic purposes. Third, a situation generally overlooked is that economic and electric growth tend to be parallel across regions, and in the case of Canada, across international boundaries. The Canadians have also been experiencing higher than anticipated growth in electric demand (5.5 percent a year in the last two years).

Thus, those who support the high growth forecast claim that a shortage of electricity supply is possible in the near future, with demand beginning to exhaust supplies between 1988 and 1990. The implications are staggering. Assuming a 10-year lead time for licensing and construction, no plant retirements, a twenty percent reserve margin, and new plant commitments of 450 million to 700 million kilowatts, investment equaling $1.5 trillion to $2 trillion are necessary over the next ten years. This compares with an effective ordering rate of zero for the past ten years. Since 1978, no new nuclear plants have been ordered and all those ordered since 1974, with the exception of two, have been cancelled. Since 1982, only one new coal plant has been ordered. Moreover, many plans for new coal and/or nuclear plants, which account for almost seventy percent of electricity generation, have been shelved. In addition, the prospect of expensive electricity in short supply may deter industries from investing in new, productivity-enhancing technology, much of which is electricity-intensive. Such technology, which would also spur economic growth, ranges from electric arc furnaces for the steel industry and robotics for auto and machine-tool industries to advanced food-processing techniques and computer technology.

On the other hand, low growth utility forecasters essentially believe that electricity faces adverse trends. With supplies plentiful, the real price of oil and gas is likely to decline until at least 1990. Conversions to electricity will slow while the price of electric power drops little, since only one-sixth of the nation's power is generated with oil and gas. In addition, these forecasters claim that personal computers are rapidly displacing energy-intensive mainframes. The use of robots on assembly lines will also save on lighting and air-conditioning. And microprocessor controls are cutting into energy usage in appliances and industrial processes. Conservation has also helped to reduce electricity consumption by contributing to the development of power saving inventions. These include fluorescent bulbs that fit incandescent sockets and produce a pleasing light with three-quarters less power; refrigerators that consume 40 percent less power than the 1980 models, and electronic variable-speed drives that cut electricity use by industrial motors in half.

More important, 'rate shock' from new nuclear plants, both completed and cancelled, will increase electric rates. The costs of most of these reactors have yet to be reflected in rates. Spread over the next five years, the nuclear rate burden will lift average rates by two percent a year, enough to offset most of the normal spur to electricity use if the economy were to grow at three percent a year. Rate impacts will be twice that in New York, which has the nation's two costliest reactors, with New England following close behind. Thus, they argue, the ingredients of an electric boom are lacking.

Conclusion

The immediate concern of high growth forecasters is whether the electric utility industry will continue to defer commitments of adding new generating capacity to coincide with realistic estimates of growth. In that case, increasing electricity prices beginning around 1990 and questions of electric utility reliability could begin to hamper electricity growth and hinder economic development as well as increase oil and natural gas consumption. Low growth forecasters, on the other hand, insist that electricity supplies are more than adequate to meet future needs. They argue that the industry should concentrate on plans to increase cogeneration (the same steam that is used for heat or industrial processes is also used to generate electricity) projects.

The policy implications of the high growth scenario are clear. If we are to continue to achieve healthy rates of economic growth, we must ensure that an electricity crisis is not looming in the near future. In effect, economic growth could be thwarted if there are inadequate supplies of electricity. Public policymakers need to take a hard look at the possible scenarios in the electric utility industry and the policy implications each one will have on economic growth.

TRENDS IN COMMERCE NOTES ON TABLE II MAY, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—The Department of Commerce's preliminary estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—indicates that the inflation-adjusted growth rate slowed to a seasonally adjusted annual rate of 1.3 percent in the first quarter. This is a significant downward revision from the flash forecast issued in March, which indicated a 2.1 percent growth rate. It is also about one-third below the 4.3 percent growth rate registered in the fourth quarter of 1984. The data continues to indicate that the consumer and business sectors have increased their spending, but these increases were offset by slowdowns in new home construction, federal purchases and in the level of exports.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.5 percent in March, resulting in a 9.6 percent (seasonally adjusted annual rate) rise in the money supply in the latest three-month period. This performance places the nation's money supply up 6.4 percent from its year-ago level.

Employment—The civilian unemployment rate remained unchanged at 7.3 percent in April for the third month in a row. Civilian employment—as measured by the monthly survey of households—decreased by 174,000 persons (seasonally adjusted), to 106.9 million, bringing the employment increase in the household survey in the last twelve months to over two and one-half million. In contrast, the number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 217,000 in April. This increase reflects the continued strength of service sector and construction employment. If working teenagers, in the 14 to 15 age group, are included in the Department of Labor data, then the actual number of persons employed exceeds 108 million.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.5 percent in March, following a 0.2 percent rise in January and a 0.3 percent increase in February. The source of the March increase was the gasoline and apparel components. This contrasted with the previous month when gasoline prices declined by 2.5 percent. Independent surveys by energy consultant Dan Lundberg show that gasoline prices have risen eight cents since February and are likely to rise another three or four cents before leveling off. This would indicate that gasoline prices will affect the consumer price index for at least the next two months.

Wholesale prices of finished goods rose 0.2 percent in March, the first increase of this year. The increase in finished goods prices was the result of a moderate rise in capital goods, women's and children's apparel, household furniture, and other consumer goods, while consumer foods prices continued to decline for the third month in a row. From March 1984 to March 1985, on an unadjusted basis, the finished goods index increased only 0.3 percent, the smallest increase for any 12-month period in 20 years.

The more volatile part of the Producer Price Index, crude goods, declined 1.2 percent in April, following decreases of 1.9 percent and 1.5 percent, respectively, in February and March. Crude materials prices in April were 8.3 percent below their levels of a year ago. Weak crude material prices appear to be a product of the strong dollar in international markets, and a surplus of farm products. Crude food and feedstuffs prices have declined nearly ten percent since the start of the year.

Housing Starts—Privately-owned housing units started in March jumped 16.2 percent, to an annual rate of 1,895,000, from the revised February rate of 1,631,000. This brought the increase over March of last year to nearly 12 percent. The surge in housing starts was mainly the result of a 54 percent increase in multi-unit starts, i.e buildings with five or more units. The number of new single family starts was up 2.5 percent in March, the highest rate since April 1984. Building permits issued in

March were up 11 percent, reaching their highest level since June 1984.

Industrial Production–Industrial production advanced 0.3 percent in March, following a 0.2 percent decline in February. Production increases were apparent in most major categories of manufactured goods. The only exception was business equipment production which declined because of continued reductions in oil and gas drilling equipment.

The capacity utilization rate for manufacturing increased 0.1 percentage points in March as factories operated at 81 percent of capacity. Although the capacity utilization rate was at about the same level as a year ago, output has increased by 2.9 percent. This increase in output was due to a continued rise in available capacity as a result of the high level of investment.

Productivity–Nonfarm business productivity declined by 1.2 percent during the first quarter, the second such decline in the last three quarters. This decline in productivity resulted from an increase in jobs of over 800,000 in the first quarter, which amounts to a three percent annual rate of growth in employment, while the economy was growing at a 1.3 percent annual rate. The decline could also be a result of a faulty measure of GNP which will be revised upward in the coming months.

Interest Rates–At 10.5 percent, the prime rate has remained unchanged for nearly four months. Most interest rates rose during February and early March, but have since returned to their levels of late January.

Business Failures and Formations–Dun and Bradstreet's Index of Business Failures indicates that business failures continued to rise in mid-April and were about four percent above the level of a year ago. The index of business failures, which uses October 1983 as a base of 100, increased to 107.8 in the week ending April 12, 1985. This was four percent above the business failure index reported a year ago. However, the number of business discontinuances was 18 percent above the year-ago level. Between January and mid-April, the number of business discontinuances increased by five percent from its year-ago level. The recent rise in business failures is largely attributed to an increase in agricultural failures.

The latest available data indicates that new business incorporations in the first eleven months of 1984 rose by 6.3 percent. The number of new business corporations formed in November 1984 was 49,585, 3.5 percent more than the same month a year ago. Michigan and Georgia made the best showing, with increases of more than ten percent.

Federal Spending–The 'Federal Spending Index,' a U.S. Chamber devised measure of the monthly change in federal expenditures, rose by 6.9 percent this March compared to its year-ago level. In the first six months of fiscal 1985, federal expenditures increased by 11 percent, about three times as fast as prices, indicating a real increase in federal spending of about eight percent from the year-ago level. Only one fifth of the increase is the result of a rise in defense spending. Receipts for the month of March were up 11.6 percent from the same month a year ago, partially as a result of the IRS delays in mailing out tax refunds. Since the federal government measures receipts on a net basis, receipts less refunds, preliminary estimates indicate that these delays have resulted in receipts appearing to be $6.7 billion higher than they would have been if the refunds had been mailed on time.

Personal Savings–According to Department of Commerce data, personal savings declined to 4.6 percent of after-tax income in the first quarter of 1985, from 6.2 percent in the fourth quarter of 1984. The reason for the decline in the savings rate appears to be directly related to the delay in mailing out tax refunds, which consumers normally rely on at this time of year. The delays in the refunds reduced after-tax income by $6.7 billion in February and March, which when translated into seasonally adjusted annual rates, amounts to over $40 billion, on average, for each of the two months.

Retail Sales–The Department of Commerce reported that sales at the retail level rose by 0.9 percent in April, following a 1.9 percent decline in March. April retail sales were 4.5 percent higher than their year-ago level. Automobile sales rose by 1.6 percent, while department store sales saw a 1.9 percent gain.

Trade Deficit–The trade deficit, on a goods and services basis, increased to $73 billion in the first quarter. The deterioration is the result of a $5.8 billion decrease in first quarter exports while imports continued to increase by $11.2 billion. The merchandise trade deficit decreased $400 million in March compared to February. The decline in the deficit was the result of a 3.3 percent increase in the value of exports which substantially outpaced the 0.7 percent increase in imports. Surprisingly, there was a $570.6 million increase in manufacturing exports for the month, hardly what one would expect after reading about the uncompetitiveness of American industry. The increase in manufacturing exports was mainly concentrated in office, advanced data processing and telecommunications equipment, and high-tech goods.

What's Ahead–The composite index of leading indicators, designed to predict future movements in aggregate economic activity, decreased 0.2 percent in March, with seven of the ten available indicators down. This follows two months of strong showings by the leading indicators series. The index of coincident in-

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Feb/85	238.1	238.0	236.0	0.1	0.9
Gross National Product ($B) [a]	I/85	3,819.9	3,758.7	3,553.3	1.6	7.5
Gross National Product (72$B) [a]	I/85	1,668.0	1,662.4	1,610.9	0.3	3.5
Money Supply (M1) ($B) [a]	Mar/85	571.9	569.3	537.3	0.5	6.4
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Mar/85	2,441.5	2,454.6	2,273.2	−0.5	7.4
Personal Consumption Expenditures (72$B) [a]	Feb/85	1,093.3	1,085.9	1,040.4	0.7	5.1
Disposable Personal Income ($B) [a]	Mar/85	2,636.8	2,649.8	2,5[illegible].7	−0.5	4.6
Disposable Personal Income (72$) [a]	Feb/85	1,180.2	1,192.6	1,149.2	−1.0	2.7
Personal Savings Rate (%)	Feb/85	4.6	5.1	6.1	−0.5[b]	−1.5[b]
Civilian Employment (millions) [a]	Apr/85	106.9	107.1	104.4	−0.2	2.4
Civilian Unemployment Rate (%) [a]	Apr/85	7.3	7.3	7.7	0.0[b]	−0.4[b]
Average Hourly Earnings [a]	Apr/85	$8.54	$8.53	$8.31	0.5	3.1
Consumer Price Index (All Urban, 67=100)	Mar/85	318.8	317.4	307.4	0.5	3.7
Purchasing Power of the Dollar (67=$1.00)	Mar/85	0.313	0.315	0.325	−0.47	−3.54
Prime Interest Rate (%)	Mar/85	10.5	10.5	11.2	0.0[b]	−0.7[b]
Retail Sales ($) [a]	Mar/85	112.2	111.3	107.4	0.9	4.5
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	IV/84	228.7	224.8	225.5	1.7	1.4
After Tax	IV/84	141.0	141.7	141.1	−0.5	−0.1
Industrial Production (67=100) [a]	Mar/85	165.4	164.9	160.8	0.3	2.9
Capacity Utilization Rate (Mfg.) (%)	Mar/85	81.0	80.9	80.9	0.1[b]	0.1[b]
New Housing Starts (thou. units) [a]	Mar/85	1,895.0	1,631.0	1,700.0	16.2	11.5
Net Business Formation (67=100)	Feb/85	118.0	117.3	117.2	0.6	0.7
New Business Incorporations (Thousands) [a]	Nov/84	49.6	52.2	47.9	−5.0	3.5
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100) [a]	I/85	162.9	160.0	158.3	1.9	2.9
Unit Nonlabor Costs (77=100) [a]	I/85	161.0	160.3	152.2	0.4	5.8
Producer Price Indices (67=100)						
Crude Materials [a]	Apr/85	311.3	312.9	339.4	−1.2	−8.3
Intermediate Goods [a]	Apr/85	319.4	318.6	320.3	0.2	−0.3
Finished Goods [a]	Apr/85	293.1	292.4	291.2	0.3	0.7
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100) [a]	Mar/85	594.4	569.9	556.0	4.3	6.9
Federal Government Debt Outstanding ($B)	Dec/84	1,667.4	1,635.5	1,415.3	2.0	17.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	I/85	361.4	367.2	358.9	−1.6	0.7
Imports of Goods & Services ($B) [a]	I/85	434.4	423.2	410.4	2.6	5.8
Balance on Goods & Services ($B) [a]	I/85	−73.0	−56.0	−51.5	30.4	41.7
WHAT'S AHEAD?						
Index of Leading Indicators (67=100)	Mar/85	167.1	167.5	167.2	−0.2	−0.1

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

dicators, a monthly approximation of aggregate economic activity, rose 0.5 percent in March, increasing for the first time in 1985.

SMALL BUSINESS OPINION POLL

The following are the tabulated results of a small business opinion poll taken at the 1985 Annual Meeting of the U.S. Chamber of Commerce. Although approximately 46 percent of the respondents said that the issues of taxes and federal regulation could pose a threat to the state of small business, a majority of those who responded said that the future of small business remained bright indeed. There were a total of 274 respondents to the survey. The figures in parenthesis next to each response represent the percent of respondents who supplied that answer. The answers to some questions may not add up to one hundred because of rounding, or because respondents were allowed more than one answer.

A. Compared to a year ago, is small business a greater or lesser force in the political arena?

(49%) Greater
(37%) Same
(12%) Less

B. What are the major problems facing small business in the coming year? (Check only two)

(44%) Taxes
(15%) Availability of skilled employees
(2%) Employee/customer crime
(8%) Mergers/acquisitions
(46%) Federal regulation
(15%) State regulation
(16%) Imports
(37%) Interest rates
(2%) Other

C. In five years, do you expect your business to be

(68%) Larger
(1%) Smaller
(21%) About the same
(1%) Disbanded
(5%) Bought out by another business
(1%) A publicly owned business

D. Does your organization provide goods or services to government?

(5%) Federal only
(12%) State/local only
(26%) Both federal and state/local
(51%) Do not do business with government

E. If you answered in question D that you do not do business with the federal government—why not? (Check all that apply)

(13%) No needed product or service
(13%) Government requires too much paperwork
(9%) Government pays too slowly
(2%) Don't know how
(10%) Not as profitable as selling to the private sector
(43%) Not applicable

F. Compared with five years ago, do you think consumers' attitudes toward business are: (Check as many as you wish)

(45%) More aggressive in protecting their rights
(34%) More aggressive regardless of right
(18%) More sympathetic to a business point of view
(15%) Have not substantially changed

G. How do you feel about the future of small business? (Check only one)

(58%) Opportunities will increase
(7%) Big business will eventually dominate everything
(12%) Status quo will continue indefinitely
(4%) Government will insure the survival of small business
(12%) Government will regulate small business out of business
(4%) No opinion

H. Do you agree that free market forces rather than federal price supports should set prices for farm commodities in the long run?

(86%) Agree
(7%) Disagree
(5%) No opinion

I. Do you favor or oppose the Administration's proposal for a youth differential to the minimum wage, which would allow employers to hire teenagers at 75% of the minimum wage in the summer?

(82%) Favor
(10%) Oppose
(7%) No opinion

J. If enacted, would your company hire new employees at the youth differential wage?

(56%) Yes
(26%) No
(13%) No opinion

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States June 1985

TAX REFORM SHOULD PROMOTE ECONOMIC GROWTH

by
Richard W. Rahn

One of the great tragedies of our time is that so few people seem to understand how economic growth occurs and, as a result, fail to fully appreciate the great benefits of rapid economic growth. This is apparent in much of the current debate about tax reform. Specifically, many politicians, commentators and self-styled "citizen advocates" are demanding large increases in corporate taxes and the institution of increased individual and corporate "minimum taxes." However, there is little, if any, discussion of how such proposals are likely to affect economic growth. Many of those who advocate tax increases suffer from acute economic ignorance. Others, and unfortunately, all too many, engage in sheer demagoguery for their own political purposes. When an economy enjoys high levels of economic growth, almost everyone benefits, particularly the poor. Higher levels of growth result in the creation of new job opportunities, raise the nation's standard of living, and reduce the poverty rate. It also increases the funds available for spending on social services, such as medical care and education.

We need to, and indeed ought to, pursue tax reform, but tax reform to make the world better, not to punish the productive. The Administration and other advocates of tax reform have said that its goal should be to promote economic growth, and simplify the tax code, while at the same time, being equitable. The relative degree to which alternative tax reform proposals promote economic growth can be projected with reasonable certainty given the current level of economic knowledge. Simplicity is a somewhat more elusive goal, but most people can judge whether a given proposal is likely to reduce or increase the number of manhours required to comply with it.

Equity is a more difficult concept since it is so laden with value judgments. But, in general, most people would agree that any reform of the tax code should result in people of like circumstances paying similar levels of tax. Moreover, lower income individuals should not pay a higher percentage of their income in taxes than do higher income individuals.

These three goals of tax reform do not have to be in conflict, and in fact, any correctly designed tax reform proposal will advance all of them simultaneously. However, the wrong kind of tax reform could slow economic growth or even throw the economy into a recession. Only tax reform that reduces tax rates without increasing the tax bias against savings and investment is unambiguously pro-growth.

Reduced tax rates will augment economic growth in three ways. First, because lower tax rates increase individuals' after-tax wages on additional work, people tend to work more. The supply of labor will increase as more people work overtime, they take second jobs, spouses enter the work force for the first time, and so on. Second, because lower tax rates increase the after-tax return on savings and investment, people tend to save and invest more. This provides the capital necessary to build additional factories or buy more or better machinery. Third, by reducing the value of various tax breaks, lower tax rates will reduce the tax-induced economic distortions that have made the economy less efficient and productive. The phased-in tax rate reduction enacted in 1981 had precisely these effects.

Currently, personal income tax rates range from 11 percent to 50 percent, while corporate income over $100,000 is taxed at a 46 percent rate. The Administration's Tax Reform plan would reduce individual tax rates to 15 percent, 25 percent, and 35 percent. Compared to the other major tax reform proposals, the Administration's plan contains the highest individual tax rates. In contrast, the Bradley-Gephardt "Fair Tax Act" has rates of 14 percent,

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26 percent, and 30 percent, while the Kemp-Kasten "Fair and Simple Tax" (FAST) has tax rates of 19 percent and 29 percent. Corporate tax rates would be reduced to 30 percent under the Bradley-Gephardt plan, 33 percent under the Administration's plan, and 35 percent under the Kemp-Kasten plan. The Kemp-Kasten and Administration plans retain lower tax rates for small corporations.

Unfortunately, many tax reform plans reduce tax rates at the expense of increasing the tax bias against savings and investment. As a result, these plans will reduce the amount of investment in job-providing plants and productivity-improving equipment. Consequently, they are likely to slow the rate of economic growth. The people that would be most hurt by the resulting stagnation of the economy are the working poor. They also stand to gain the most from a dynamic, growing economy with high employment and an increasing standard of living. There are three critical factors that must be weighed to determine whether a plan has a constructive, pro-growth treatment of savings and investment.

First, the plan must have adequate capital cost recovery or depreciation allowances. Until the enactment of the Economic Recovery Tax Act of 1981 (ERTA), the tax law discriminated against capital investment. Capital expenses incurred in a given year had to be deducted over a dozen or more years even though virtually all other business expenses were deductible in the year incurred. An unbiased tax code would allow capital expenses to be deducted in the first year just like other business expenses. The Accelerated Cost Recovery System (ACRS), enacted under ERTA, dramatically simplified the tax treatment of capital investment and shortened the period over which capital expenses were deducted. In combination with the investment tax credit, ACRS has approximately the same economic effect of simply deducting the capital expense in the year incurred (often called first-year expensing). This dramatic move toward tax neutrality has caused investment to boom. So far, in the recovery, investment has grown twice as quickly as average and at a stronger rate than any recovery since World War II. The Kemp-Kasten proposal achieves approximate economic neutrality with its Neutral Cost Recovery System (NCRS), which is designed to provide the equivalent of first-year expensing. The Administration and Bradley-Gephardt plans, however, would return to systems worse than those existing prior to 1981. Because they would dramatically increase the cost of capital, investment would fall and economic growth would slow down.

Second, no constructive reform plan should increase the tax rate on capital gains. In 1978 and 1981, the capital gains tax rate was reduced. Following both tax rate reductions, the government received more tax revenues from the capital gains tax. Moreover, new issues of securities increased dramatically, investment in entrepreneurial activity skyrocketed, and markets became more efficient. Because of this increased taxable economic activity and a reduced tax disincentive to realize capital gains, the government actually profited greatly from lower tax rates. More importantly, however, the American people had more opportunities and a higher standard of living (see *Boosting Capital Formation and Tax Revenues: The Case of Capital Gains Tax Rate Reduction,* in this issue). The Bradley-Gephardt plan would raise the capital gains tax rate dramatically, while Kemp-Kasten and the Administration plans would reduce it.

Third, constructive tax reform plans should build on the Individual Retirement Account (IRA) concept. Money placed in IRAs is deducted from taxable income and taxed only upon withdrawal. IRAs virtually eliminate the tax bias against selected savings. The Administration plan would raise the contribution of a nonworking spouse to $2,000 from the current $250.

Only the Kemp-Kasten FAST plan is unambiguously pro-growth. The inadequate capital cost recovery allowances in Bradley-Gephardt and the Administration plans threaten to undo all of the other positive aspects of those plans. The Congress, in considering tax reform, should ensure that damaging capital cost recovery provisions and capital gains taxation do not make it through the policy process into law.

Fundamental tax reform could cause economic growth of unequalled strength in this country. But we must ensure that in an attempt to be "fair", we do not misguidedly adopt a tax reform plan that will cause economic reverses that most harm the least advantaged members of our society.

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ECONOMY FLASHES MIXED SIGNALS

by

Rajni Bonnie Ohri and Graciela Testa-Ortiz

At first glance, the news that the nation's gross national product increased at an annual rate of 0.7 percent in the first quarter, slower than the preliminary estimate of 1.3 percent, was surprising. The figure revived unfounded fears that the economy might be stumbling into a "growth recession," as Federal Reserve Vice-Chairman Preston Martin called it.

Economic data, however, continue to provide mixed signals which lend themselves to a different interpretation of the economy's health as well as to future prospects. Downward revisions to business investment, government purchases, and net exports outweighed higher estimates of consumer spending and residential investment during the first quarter. It is interesting to note that, since the third quarter of last year, swings in real inventories have largely offset swings in net exports, suggesting that while domestic demand remains strong, much of it is being satisfied by imports. Reflecting the economy's current strength, consumer spending grew at a strong 5.2 percent annual rate during the past quarter, while new housing starts increased by 47.8 percent. The improvement in housing continued in April as starts reached 1.9 million units, their highest level in nearly a year. On the other hand, growth of business fixed investment continued to slow in the first quarter, posting a 2.6 percent annual rate of increase, the smallest since the first quarter of 1983. These divergent trends have caused some confusion regarding the overall direction of the economy. Although that direction may be obscured temporarily by factors such as the strong dollar and the prospects for tax reform, the stage is being set for a rebound in domestic production.

In particular, recent action by both the House and Senate on a package of budget reductions which is likely to be enacted before summer's end, will go a long way towards resolving the deficit problem without resorting to counterproductive tax increases. At the same time, there is reason to believe that once the spending cuts are enacted, the Federal Reserve, in keeping with previous pronouncements by Chairman Volcker, will move to ease monetary policy further. In fact, the Federal Reserve has already cut the discount rate, from 8 percent to 7.5 percent, bringing it to the lowest level since August 1978. In addition, after remaining unchanged for four months at 10.5 percent, the prime rate, as expected, fell to 10 percent in May. Further decline in the prime rate, to single digit levels, is anticipated to occur within weeks. As a result of these policy changes, both residential and nonresidential investment are expected to rebound by mid-year. By the end of 1985, new housing starts should reach the two million unit level. Business fixed investment could rise by 15.5 percent by the end of 1986.

Consumer spending will also contribute to second quarter strength. Delayed payment of tax refunds during the first quarter mean larger than normal refunds during the second quarter. While the resulting increase in disposable income will most likely be saved, some increase in consumer expenditures should also occur. Therefore, the outlook for consumer purchases, including autos, remains relatively strong as consumer optimism is bouyed by recent declines in interest rates and continued employment gains. Indeed, retail sales have recovered from their March slump and are now nearly 5 percent higher than their year-ago level. Further, domestic auto sales surged in mid-May reaching an 8.9 million unit annual rate. To keep up with expected strong demand, domestic car manufacturers' second quarter production plans call for the highest output levels since 1977-78.

While the trade situation may continue to deteriorate this quarter, the deficit is not likely to widen as rapidly as it did during the first quarter. Since it is the rate of change in the trade deficit, not its size, that influences the GNP figures, this bodes well for measured GNP during the second quarter. However, for the year as a whole, net exports will remain a major drag. Even though we expect a steady decline in the exchange value of the dollar, its effect on imports will not be felt immediately. Initially, foreign suppliers are expected to be successful in protecting their market shares by resisting dollar price increases. However, if the decline in the dollar's value accelerates, then import price increases will become more evident. As a result, import volumes may decline, but total dollars spent on imports may not. In sum, imports are expected to remain strong throughout the remainder of this year, rising by 8.3 percent. On the other hand, the expected decline in the exchange rate will improve the competitiveness of U.S. exports. By 1986, real export growth should outpace real import growth.

Labor market improvements appear to have reached a plateau in recent months, with the civilian unemployment rate remaining at 7.3 percent in May, showing little or no change since August 1984. However, two major employment statistics set new records in March: the civilian employment to population ratio climbed 0.2 percentage points to 60.3 percent, while the participation rate reached 65 percent. The monthly survey of establishments indicates that nonfarm employment rose by 381,000 in March, the largest increase since April 1984.

In sum, given the first quarter's weakness, this month's forecast shows real GNP growing by 3.2 percent in 1985 and 4.2 percent in 1986, on a year-over-year basis. Quarterly growth rates are expected to remain in the neighborhood of 4.5 percent, a very healthy rate for the third year of expansion. The civilian unemployment rate averages 7.2 percent this year and 6.9 percent in 1986. Inflationary pressures remain moderate while interest rates continue to edge downwards.

As mentioned, the major threat to the current expansion stems from the continued deterioration of the trade balance and the growing protectionist sentiment in this country. However, fiscal policy risks also loom heavily on the horizon. While progress in reducing federal spending is encouraging and, once enacted, should prove to be very beneficial to the overall economy, uncertainty about the final form of the tax package may take the wind out of the expansion. In particular, the enactment of a tax reform plan which does not preserve savings and investment incentives will be very onerous, indeed, as detailed in the previous article.

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1983-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS									YEARS			
	Actual		Forecast							Actual		Forecast	
	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1983	1984	1985	1986
GROSS NATIONAL PRODUCT													
Real GNP	4.3	0.7	4.4	4.9	3.4	4.9	4.3	3.8	3.0	3.7	6.8	3.2	4.2
Consumption	3.6	5.2	3.4	4.1	4.5	3.6	3.7	3.3	3.4	4.8	5.3	4.0	3.8
Residential Investment	-5.9	1.4	14.7	27.2	14.4	5.9	7.1	-4.6	-8.0	41.7	12.2	5.4	8.2
Business Fixed Investment	8.5	2.6	5.8	9.6	10.0	8.7	7.3	8.5	10.1	2.5	19.8	8.0	8.7
Equipment	5.4	-2.5	5.5	9.3	10.2	9.7	8.3	10.1	11.5	7.3	21.5	6.6	9.4
Structures	17.2	16.8	6.8	10.1	9.3	6.1	4.7	4.5	6.5	-7.8	15.6	11.9	6.8
Exports	-0.8	-6.1	6.1	7.7	9.3	8.7	8.2	8.6	11.3	-5.6	4.7	1.8	8.6
Imports	-28.3	31.3	0.3	9.2	5.7	7.6	6.0	6.4	5.7	7.6	27.0	8.3	6.4
Government Purchases	5.9	-1.8	6.8	3.1	-9.5	3.7	2.8	2.7	-4.7	-0.3	3.5	3.4	0.4
Inventory Change ($B)	37	41	33	33	38	44	45	46	49	-13	58	36	46
New Car Sales (mil. units)	10.4	10.8	10.9	10.9	11.1	11.2	11.4	11.5	11.5	9.2	10.4	10.9	11.4
Housing Starts (mil. units)	1.6	1.8	1.9	1.9	2.0	2.0	2.0	1.9	1.9	1.7	1.8	1.9	1.9
EMPLOYMENT, WAGES AND PRICES													
Unemployment Rate (%)	7.2	7.3	7.3	7.2	7.1	7.1	7.0	6.9	6.9	9.6	7.5	7.2	6.9
Compensation	3.6	5.5	4.3	4.3	4.1	6.0	4.9	5.1	5.2	4.8	4.2	4.3	4.9
Productivity	2.3	-2.5	3.6	2.4	3.1	2.5	2.2	2.6	2.6	3.4	2.7	1.1	2.5
Unit Labor Costs	1.3	8.1	0.7	1.9	0.9	3.4	2.7	2.4	2.6	1.3	1.4	3.2	2.3
Consumer Prices	3.5	3.3	4.3	3.1	3.3	3.7	3.6	3.6	3.6	3.2	4.3	3.6	3.6
GNP Deflator	2.8	5.6	2.6	2.8	3.3	3.5	3.3	3.2	3.8	3.8	3.8	3.7	3.3
Prime Interest Rate (%)	11.8	10.5	10.1	9.5	9.3	9.2	8.7	8.4	8.8	10.8	12.0	9.9	8.8
Profits from Current Production ($B)*	203.9	209.8	214.3	220.1	228.5	233.7	242.5	245.7	247.1	149.4	195.9	218.2	242.3
GOVERNMENT FISCAL POLICY ($BILLION)**													
Unified Budget–Receipts										601	666	740	801
Unified Budget–Outlays										796	842	954	972
Unified Budget–Federal Surplus or Deficit										-195	-176	-214	-171

*Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

SOURCE: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's second revision to the National Income and Product Accounts for the first quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government spending of $50 billion in 1986. Federal government purchases, on an NIA basis, grow at an average annual rate of 2.5 percent between 1984 and 1986. The nation's money supply, as measured by M(1), rises by 7.9 percent in 1985 and 6.6 percent in 1986. The federal minimum wage remains at $3.35 per hour throughout the forecast horizon. The price of imported crude oil averages $27.28 in 1985 and $26.19 in 1986 compared to $28.87 in 1984 and $29.35 in 1983. The trade-weighted exchange value of the dollar falls by 4.5 percent by the fourth quarter of 1985 compared to the same quarter in 1984. During 1986, it falls by 8.4 percent.

ECONOMIC STAGNATION AND GOVERNMENT GROWTH: SOME NEW EVIDENCE

by
Ronald D. Utt

By all accounts, the writing of the President's address to the European Parliament in May was the subject of a struggle within the White House over how bold the President should be in advising Europe's leaders on matters of economic policy. This struggle, fought between those who would have the President challenge the European leaders to spur growth by policies that relied on free market solutions, limited government and tax relief, and those who would have him limit his remarks to predictable platitudes that would neither inspire nor offend, was won by the diplomats.

It's too bad it turned out this way since, in retrospect, the President had everything to gain and nothing to lose by being forthright in his advocacy of solutions of proven performance. Certainly, the Europeans, heavily taxed and now mired in nearly a decade of economic stagnation, should have been given the opportunity to hear the President out on his vision for the West. Heaven knows, we've suffered often enough from their advice on any number of strictly domestic issues.

Aside from the issue of whether such a speech was impolitic or not, the existence of divergent economic policies among comparably endowed nations offers us unique analytical opportunities to compare national performance under different approaches to government taxing and spending. As this article demonstrates, the low-tax/low-spend countries have outperformed those with large and rapidly growing government sectors. Such an analysis also shows that the lack of fiscal discipline we have experienced is a worldwide phenomenon and that the situation abroad is often worse than our own.

In recent years, many economists and policy analysts have focused on the rising burden of taxation throughout the world, noting distinct differences in economic performance between low-tax and high-tax countries. Generally, the low-tax countries out-performed the others by a wide margin in terms of economic growth and improvements in the standard of living. Seldom, however, have these analysts taken the one step backward to determine the cause of burdensome taxation—rapidly rising government spending which absorbs ever larger shares of a nation's economic output.

One of the first to formally address this destructive trend toward excessive spending and taxing in the major industrial countries was J. de Larosier, Managing Director of the International Monetary Fund. In a 1982 paper titled, *Restoring Fiscal Discipline: A Vital Element of a Policy for Economic Recovery,* Mr. de Larosier placed the blame squarely on the changing attitudes about the role of government and how these changes led to a rapid rise in spending. In turn, this rapid growth in spending forced governments to raise taxes to the point where economic growth and productivity suffered.

Three years later, the fiscal imbalances he observed have only worsened, as have the economies of those countries with the highest taxes. From 1965 to 1980, the ratio of total government spending to gross domestic product (GDP) for the seven major industrial countries rose from 30 percent to 39 percent. Over the same period, the tax share rose from 29 percent to almost 36 percent, with the collective deficit rising accordingly. Two years later, the spending share for the same seven countries

TABLE 1
TOTAL OUTLAYS OF GOVERNMENT AS A PERCENTAGE OF GDP

Country	1965	1980	1982
United States	27.9%	35.0%	37.6%
Japan	20.0	32.4	34.5
Germany	36.7	48.3	49.4
France	38.4	46.4	50.7
United Kingdom	36.4	45.4	47.4
Italy	34.3	46.1	53.7
Canada	29.1	41.0	45.8
Average	30.1	39.3	41.4
Belgium	32.3	51.1	56.6
Denmark	29.9	56.2	60.7
Netherlands	38.7	59.5	63.7
Sweden	36.1	62.1	67.3

Source: Organization for Economic Co-operation and Development

TABLE 2
RECEIPTS (TAXES AND FEES) OF GOVERNMENT AS A PERCENTAGE OF GDP

Country	1965	1980	1982
United States	26.5%	32.0%	32.0%
Japan	19.5	28.0	30.2
Germany	35.7	44.6	45.3
France	38.4	45.5	46.9
United Kingdom	33.4	40.5	43.7
Italy	30.1	37.8	41.5
Canada	28.1	37.1	39.0
Average	28.9	35.6	36.0
Belgium	30.7	43.0	45.4
Denmark	31.2	52.2	50.7
Netherlands	37.3	55.0	55.8
Sweden	39.6	57.1	59.7

Source: Organization for Economic Co-operation and Development moved above 41 percent while taxes held steady at 36 percent of GDP. Tables 1 and 2 provide details on the changes for these countries, as well as even more dramatic trends in several other industrial nations.

As these two tables clearly illustrate, from a position of near balance in 1965, the government budgets of the leading seven countries slipped further into the red as the years progressed. And while tax burdens moved up sharply as well, they failed to keep pace with government spending, which now exceeds 50 percent of GDP in two of the seven and six of the eleven countries presented above.

When Mr. de Larosier wrote his paper, he could only speculate on the damage this trend might do. Although there were ample signs of economic deterioration at the time, it was difficult to separate this factor from the world recession that characterized 1982, and from the energy price shocks that battered the world economy during much of the 1970s. But with these events now behind us and a world economic recovery underway, we have a much greater sense of the damage that has occurred in those countries, particularly in Europe, at the top end of the tax and spending scale.

At the risk of over-simplification, the process of economic deterioration from excessive growth in government follows a pattern which, in its later stages, becomes nearly involuntary and self-fulfilling. It begins by accepting broader responsibilities for government which, in order to be fulfilled, necessitate an increase in government spending as a share of a country's national income. This leads to greater government budget deficits and/or higher taxes. If central banks print more money in a vain effort to offset the impact of the deficit, then inflation worsens and this further drives up tax receipts as rising nominal incomes confront progressive income tax systems. Either way, the tax burden rises in response to growing expenditures.

At some point, the rising tax burden begins to create a strong disincentive to work, to invest and to engage in entrepreneurial activity which, in turn, contribute to a slowing of economic growth and job creation. Unemployment begins to rise, other social problems emerge and the demand for government services and support increases. Government spending rises further, as do the taxes necessary to fund it, and the process repeats itself, but this time with greater vigor because the worsening economic environment deepens the perceived need for greater government services. It goes on and on like this until there emerges a situation like that of Sweden or the Netherlands where the government accounts for about two-thirds of the economy.

Measures of economic deterioration over time and among countries abound. Perhaps the clearest indication of decay is the dramatic decline in economic growth for the seven major industrial countries since 1965. Table 3 lists the average annual rate of growth in real GDP for these countries at five year intervals beginning in 1965.

TABLE 3
AVERAGE REAL GDP GROWTH FOR THE SEVEN MAJOR INDUSTRIAL COUNTRIES
1965 TO 1984

Period	Annual Average Real Growth in GDP
1965-69	5.04%
1970-74	3.62
1975-79	3.28
1980-84	1.84

Source: Organization for Economic Co-operation and Development

Among countries, differences in performance over time correspond closely to relative tax and spending burdens, particularly over the past few years when high tax Europe has been slow to recover while Japan, the U.S. and Canada, with lesser tax and spending burdens, have experienced strong business expansions. Indeed, absent the powerful U.S. recovery which has drawn in abundant imports from abroad, the European situation would be even more anemic. Table 4, which ranks industrial production performance for the same seven countries from 1980 to 1984, offers a dramatic illustration of the differences. The figure in parentheses provides the countries' rank within the seven according to the government's share of spending in the economy as measured in Table 1. Note the perfect correspondence between industrial decay and government encroachment.

TABLE 4
INDEXES OF INDUSTRIAL PRODUCTION
1980 = 100

Country	1981	1982	1983	1984
Japan (7)	101.0	101.4	104.9	116.5
United States (6)	102.6	94.2	100.3	111.1
Canada (5)	100.9	90.1	95.5	1038
United Kingdom (4)	96.3	98.0	101.9	102.8
Germany (3)	98.4	95.4	96.2	99.6
France (2)	96.8	95.3	96.5	98.6
Italy (1)	99.8	97.5	91.8	95.2

Source: U.S. Department of Commerce

There is an interesting side note to the above trends as they relate to the current domestic debate about the value of the dollar and its ramifications for U.S. industry. Some of those concerned about the dollar's rise relative to other currencies argue that it is leading to the "deindustrialization" of the United States and the economic benefit of our international competitors. Ironically, as the table illustrates, it is those countries whose currencies have declined the most against the dollar (Italy and France) that are experiencing the severest industrial problems.

Perhaps the clearest difference, at least in human terms, in national performance is the number of jobs created in these countries. Again, as Table 5 shows, the lower tax and spending countries have outperformed the others in creating new employment opportunities. Indeed, several of the high-tax/high-spend countries experienced actual declines in total employment over the past several years.

TABLE 5
INDEX OF EMPLOYMENT
1977 = 100

Country	1980	1982	1984
United States	107.7	108.0	113.9
Canada	110.8	110.2	113.8
Japan	103.5	105.5	107.9
Italy	102.9	103.0	102.7
France	100.2	99.6	98.3
Germany	103.0	100.3	98.3
United Kingdom	100.8	95.4	95.9

Source: U.S. Bureau of Labor Statistics

Since the above table makes no distinction between jobs in the public or private sector, the historical index actually overstates the employment creation performance of many of the European countries. Between 1960 and the present, a period during which all countries gained in total employment, Belgium, the United Kingdom, Italy and Germany all lost jobs in the private sector. In other words, what job growth occurred was accounted for by the government. Recently, even those European countries that did create private sector employment over the last twenty-five years began to experience deterioration during the 1980s which could, in turn, lead to a net loss in private employment within the next several years. In the United States, by contrast, jobs in the private sector expanded by fifty percent over the same period.

Employment growth, or the lack thereof, is one measure of job opportunities. Another is the unemployment rate. Here again, the U.S. is doing well, although international comparisons tend to be distorted by the extent to which government jobs programs maintain "employment" when stagnation occurs. While the U.S. unemployment rate has stabilized at 7.3 percent over the past several months, European unemployment rates have stayed above 10 percent for the last few years. The Netherlands leads the list with 16 percent of the work force unemployed, Italy comes in a close second at 14.2 percent. Belgium weighs in at 14.1 percent and the United Kingdom follows behind at 13 percent, up from 12.5 percent a year ago despite the gradual improvement in its economy.

In the end, what really matters from the point of view of the average citizen is what has happened to his or her standard of living over time. Indeed, if anything distinguishes this century from all of those that have preceded it, it is the rapid gains that have occurred in the material welfare of much of the world's population. And although the "standard of living" can be a difficult measure to record and compare, real per capita income comes the closest to measuring material well-being. Again, as in the case of all of the above measures, trends in real per capita income closely track, in an inverse fashion, the growth of government intrusion in the industrialized countries.

Table 6 illustrates the changes that have occurred recently in the real per capita incomes of the seven major economies. All comparisons are expressed in terms of an index based on the level of U.S. per capita income. Per capita income in the U.S. is expressed as 100 with the per capita income of the other countries expressed as a percentage of ours. Japan, for example, with an index value of 75.6 for 1984, had in that year a real per capita income equal to 75.6 percent of that of the United States. One other adjustment that has been made is to express the numbers in terms of "purchasing power parity" exchange rates to avoid distortions caused by wide swings in exchange rates. Otherwise, the U.S. lead would be even greater as a result of the dollar's appreciation against other currencies.

TABLE 6
PER CAPITA GROSS DOMESTIC PRODUCT BASED ON PURCHASING POWER PARITIES
(United States = 100)

Country	1975	1980	1984
United States	100.0	100.0	100.0
Canada	101.8	100.3	95.6
Japan	65.5	71.2	75.6
France	77.5	78.9	75.8
Germany	77.3	81.8	78.5
Italy	60.5	63.7	59.7
United Kingdom	70.2	67.4	65.9

Source: U.S. Bureau of Labor Statistics

With the exception of Japan, which has maintained firm limits on the growth of government spending and taxing, all countries have seen their real per capita incomes fall relative to that of the U.S. Referring back to Tables 1 and 2, there is again a striking correspondence between government growth and economic deterioration. Canada, for example, which matched the U.S. during the 1970s, saw its standard of living slip relative to ours as its government's degree of spending intrusion grew at a rate 65 percent greater than our own during the last twenty years.

Unfortunately, it is not at all clear whether they, or any of the other nations surveyed in this article, have recognized this as a problem yet. Canada, with a conservative government confronting a budget deficit almost twice ours in proportion to its economy, has opted to raise taxes as part of the "solution". In its first budget, the new

Progressive Conservative government proposes a 5 percent surcharge on corporate income tax obligations and a 5 percent to 10 percent surtax on households with income of $40,000 or more. A surtax, of course, is one of the most destructive to economic incentives because it directly raises tax rates.

Although our friends abroad do not seem to fully appreciate the gains attributable to limited government, tax rate reductions and an emphasis on market solutions, there is growing evidence that our own elected representatives from both parties have recognized this and, after some early disenchantment, are now committed to maintaining the goals of the policies enacted in 1981. In the last two months, both the House and Senate enacted separate budget resolutions that entailed spending cuts in excess of $50 billion next year without any increase in taxes. If these spending cuts are ultimately enacted in conjunction with a tax reform package conducive to a strong economy, then the remainder of the decade should see vigorous economic growth for the United States and a further widening of the differences between us and many of the other industrialized countries.

BOOSTING CAPITAL FORMATION AND TAX REVENUES: THE CASE OF CAPITAL GAINS TAX RATE REDUCTION

by
William Orzechowski

Since 1978, we have had a significant reduction of the capital gains tax rate. Over this time period, capital formation, new business ventures, and entrepreneurial activity have received a tremendous boost. New funds raised by venture capital firms have soared and public stock offerings by emerging corporations have exploded. Reductions in the capital gains tax rate have been associated with large increases in the value of corporate equities and in capital gains realizations. As a consequence, over the past five years, capital gains tax revenues have actually increased by almost 50 percent.

The experience with capital gains tax reduction is a clear illustration of the principal axioms of classical economics which maintain that taxation's most important impact is upon incentives. Adam Smith, for example, argued that high marginal tax rates, "obstruct the industry of the people and frequently affords a smaller revenue to the government than what might be drawn from more moderate taxes." Adam Smith's analysis, developed over 200 years ago, continues to be sound advice today. This is especially true in the case of capital gains tax reduction which has been a major spark in the resurgence of the U.S. economy and has led to an increase in tax revenues collected. Hopefully, this lesson will not be wasted on modern day tax reformers, many of whom want to re-establish higher taxes on capital gains.

Capital Gains History

The Revenue Act of 1951 established a maximum tax rate on capital gains of 25 percent that remained in effect until 1969. Most analysts agree that such a favorable rate contributed greatly to the rapid expansion of venture capital and research and development (R&D) activity during those years. Beginning in 1969, through various stages, the 25 percent maximum rate was severely limited and, with the Revenue Act of 1976, was nearly doubled to 49 percent.

In general, the period of rising capital gains tax rates—1969 to 1978—was a period of stagnation for American entrepreneurial activity. Associated with the abrupt rise in the taxation of capital gains was a sharp decline in new funds raised by venture capital firms. As funds for venture capital firms dried up, the development of new and growing companies was nearly stopped in its tracks. This is reflected in the massive decline in new capital raised by emerging companies (see Table 1). The period was crowned with a steady erosion in the value of corporate equities (see Table 2).

TABLE 1
NEW CAPITAL RAISED THROUGH INITIAL PUBLIC STOCK OFFERINGS (IPOs) AND VENTURE CAPITAL FORMS

YEAR	NUMBER OF IPOs	IPOs ($ millions)	NEW FUNDS RAISED BY VENTURE CAPITAL COMPANIES ($ millions)
1969	1,026	$ 2,605	$ 171
1970	358	780	97
1971	391	1,655	95
1972	568	2,724	62
1973	100	330	56
1974	15	51	57
1975	15	265	10
1976	34	234	50
1977	40	153	39
1978	45	249	570
1979	81	506	319
1980	237	1,397	900
1981	448	3,215	1,300
1982	222	1,446	1,700
1983	884	12,619	4,100

Explanation: IPOs refer to new capital issued through initial public stock offerings of corporations. This capital flows largely to relatively young and rapidly growing companies.

Source: Going Public: The IPO Reporter (Philadelphia, PA)

TABLE 2
TOTAL MARKET VALUE OF CORPORATE EQUITIES
1959–1982
($ Billions)

Phase I
A Period of Relatively Favorable Tax Treatment for Long-Term Capital Gains

Year	Amount
1959	$ 454.0
1960	451.0
1961	574.0
1962	505.7
1963	597.0
1964	662.1
1965	749.0
1966	682.2
1967	868.2
1968	1032.6

Phase II
A Period of Rising Tax Rates on Individual Capital

Year	Amount
1969	$ 913.9
1970	906.2
1971	1059.2
1972	1197.2
1973	948.1
1974	676.9
1975	892.5
1976	1052.0
1977	991.3

Phase III
Tax Rates on Individual Capital are Progressively Reduced

Year	Amount
1978	$1034.2
1979	1231.3
1980	1635.9
1981	1568.5
1982	1810.2
1983	2150.7

Explanation: The figures for corporate equities – total at market value includes the year-end market value of stocks listed on the New York and American Stock Exchanges, other stock exchanges, an estimate for all stocks traded over-the-counter, and an estimate for closely-held stocks. From this total are subtracted investment company shares, shares of foreign corporations, and intercorporations, and intercorporate holdings. The data are compiled by the Securities and Exchange Commission, (SEC).

Source: Federal Reserve Bank: *Flow of Funds,* Year-end outstanding.

A dramatic shift toward pro-capital formation tax policy occurred in 1978 when members of Congress introduced legislation to reduce the excessive tax rate on capital gains. That year, the maximum capital gains tax rate was cut from 49 percent for individuals to 28 percent.

The 1978 capital gains tax rate reduction was the first of a series of changes which progressively reduced tax rates on individual capital. Other important steps include the reduction in the top rate on investment income from 70 percent to 50 percent, which eliminated the distinction between earned and unearned income, and the 25 percent reduction in marginal income tax rates in 1981-83 which also reduced effective tax rates on capital gains. The top tax rate on individual long-term capital gains has thus been reduced from just under 50 percent to 20 percent.

Early in the 1978 debate to cut capital gains tax rates, skeptics said that such measures would do little for capital formation and would erode government revenues. President Carter argued for an even higher capital gains tax rate stating that the government's tax take would increase further as a result. According to Carter's Treasury Secretary, Michael Blumenthal, "Rolling back capital gains taxation to pre-1969 rates would reduce annual tax revenues by $2.2 billion." However, the actual record shows just the opposite. The capital gains tax rate reduction has meant much more, *not* less, tax revenue, and it has contributed to a significant increase in capital formation in a variety of ways.

Capital Markets

First, since lower tax rates on capital gains increase the rewards for risk taking, it is understandable that those investment activities that involve the most risks would feel the sharpest impact of the change. In fact, the amount dedicated to organized venture capital rebounded from an average of $70 million per year in the years 1969 through 1977 to an average of just under $1.5 billion per year between 1978 and 1983, with total dedications of $1.7 billion in 1982 and $4.1 billion in 1983. This is the nation's seed capital, from which thousands of new companies are started each year.

Second, the favorable effect of capital gains tax rate reduction is clearly seen in the dramatic rise of initial public stock offerings. This source of capital helps finance the development of young and rapidly growing firms. Table 2 illustrates the strangling effect of higher capital gains taxes upon capital formation, as new capital raised through initial public stock offerings (IPOs) crumbled from almost $1 billion in 1969 to a bare trickle of $15 million in 1975. By contrast, after the capital gains reductions began in 1978, there has been a veritable explosion in new capital formation with over $12 billion raised through initial public stock offerings in 1983.

Third, the performance of the equity markets has improved substantially. The nine-year depression in equity values which began in 1969, when tax rates on capital gains were raised, ended early in 1978 when the trend toward lower taxes on capital income began. Since the end of 1977, the value of corporate equities has risen substantially. Other economic factors have most certainly been responsible for some of the increases, including the improved outlook for lower inflation and the prospects for economic growth. Yet, gains throughout 1978-80 took place in spite of worsening inflation and rising interest rates. The common thread throughout the period has been the progressive reduction in tax rates on individual capital. The data for 1980 through 1983 is just as impressive as equity values continued to surge (See Table 1).

Tax Rates and Tax Revenues

In 1978, opponents of lower capital gains taxes argued that the reduction would cost the Treasury over $2 billion in revenue. Voicing Treasury's opposition to the 1978 proposal to reduce capital gains tax rates, Secretary Blumenthal asserted, "The measure would do little for capital formation on its own and would waste revenues." The facts paint a much different picture (See Table 3). Capital gains tax revenues have steadily *increased* even though the maximum tax rate was cut by more than 50 percent.

TABLE 3
TAXES PAID ON CAPITAL GAINS

Year	Capital Gains (billions)	Tax Rate (percent)	Tax Revenue (billions)
1967	$13.7	25.0%	$4.1
1968	18.0	25.0	6.0
1969	14.6	42.5	5.5
1970	9.0	42.5	3.3
1971	13.1	42.5	4.3
1972	17.1	42.5	6.6
1973	16.7	42.5	5.3
1974	13.5	42.5	4.2
1975	14.1	42.5	4.5
1976	18.6	49.0	6.6
1977	20.6	49.0	6.6
1978	23.2	49.0	8.1
1979	28.4	28.0	10.9
1980	29.7	28.0	11.6
1981	30.8	20.0	12.5
1982	34.4	20.0	12.9
1983	45.1	20.0	13.9

Explanation: The tax rate used in the table is the effective maximum tax rate on capital gains above $50,000.

Source: Federal Taxes in Historical Perspective, Office of Economic Research, February 1982, New York Stock Exchange.

The figures on tax revenues are remarkable. When the capital gains tax rate was raised in 1969, tax revenues from capital gains stood at $5.5 billion. However, even though the maximum tax rate had been doubled after 1969, tax revenues averaged only $5.3 billion per year from 1969 to 1978 (the period of high capital gains taxes). In stark contrast, after the capital gains tax rate had been sliced by nearly half in 1978, tax revenues from capital gains averaged $11.1 billion per year. This provides substantial evidence for Adam Smith's dictum that moderate taxation often provides government with more revenues than do higher levels of taxation.

Nonetheless, skeptics continue to question the incentive effects of capital gains tax reduction, arguing that the revenue increases can be explained by "unlocking". This occurs when tax rates are high enough to discourage investors from realizing their capital gains. Decreases in rates would then encourage some investors to realize their capital gains. Tax revenues are then given an "artificial" boost. In this case, revenue increases are hypothesized to be the result of a short-term churning of assets rather than more investment due to better incentives. However, this argument is severely discounted by the long term-rise in realizations and tax revenues that have occurred, suggesting that there exist more powerful forces than short-term unlocking. Moreover, survey data compiled recently by Roger Premus for the Joint Economic Committee indicates that capital gains tax reduction has been the most important factor in the massive rise in capital flowing to venture capital firms. Over 80 percent of the firms surveyed ranked capital gains tax reduction as an extremely important factor in the post-1978 surge in venture capital.

Soaking the Rich

To some, reductions in the capital gains tax rate represent the most persuasive case for tax rate incentives. The argument is simple: lower tax rates on capital gains entice individual investors out of tax shelters, loopholes, and consumption by making taxable investments such as equities, bonds, and plant and machinery more attractive. The results are more production and employment, and greater tax revenues paid by the rich. In the words of Calvin Coolidge, "there is no escaping the fact that when taxation of large incomes is excessive, they tend to disappear."

The evidence thus far indicates that Coolidge was right due to the appearance of greater income reported by wealthy individuals. The so-called "fat cats" are paying more capital gains taxes than ever before. Those with incomes over $100,000 included $11.7 billion of net capital gains in adjusted gross income in 1979, an increase of 72 percent over the $6.8 billion reported for this group in 1978. Since tax reduction was approximately 50 percent for these individuals, the 72 percent increase in reported capital gains means that the tax cuts paid for themselves in upper income brackets, actually generating higher tax revenues. Internal Revenue Service (IRS) data show a similar trend in 1980 as the high-income group reported $12.7 billion in net capital gains.

Likewise, IRS figures for 1982 indicate the same phenomenon. Taxpayers earning more than $75,000 yearly reported a 30 percent surge in capital gains income. This exceeded the reduction in the effective capital gains tax rate that occurred in 1981 when the top rate on investment income was reduced from 70 percent to 50 percent (a reduction of 28 percent). The most spectacular surge in gains occurred in the over $1 million income group who reported an 80 percent increase in capital gains. It is estimated that with the lower rates that were in effect in

1982, U.S. millionaires paid 30 percent *more* taxes than they did in 1981.

Conclusion

The Revenue Act of 1978 ushered in a new era of entrepreneurial activity in the American economy. Skeptics at that time said the 1978 capital gains tax cuts would do little for capital formation and do much to erode government revenues. On both counts they have been proved wrong. Instead of tax revenues falling by almost 25 percent as predicted by Carter Administration officials, the cuts in the capital gains tax rate actually boosted yearly tax revenues by almost double. The 1978 capital gains tax experiment was a success. It is a testament to the power of marginal tax rate reduction in unleashing incentive effects.

GOVERNMENT NUMBERS: CAN YOU TRUST THEM?

by
Martin Lefkowitz

The dismay and consternation surrounding the recently issued first quarter GNP report makes this an appropriate time to examine government data. On May 21, the Department of Commerce announced that the nation's gross national product rose by only 0.7 percent, about one-fifteenth the growth rate registered during the first quarter of last year. Even more disturbing, however, is the size of the revision to the first quarter's growth estimate. The Commerce Department first issued the data for the first quarter of 1985 on March 21, and at that time estimated that growth in the nation's output of goods and services would rise at a 2.1 percent annual rate. One month later the rate of growth was revised down to 1.3 percent. Now, the Department of Commerce reports that growth in the economy was even slower. The current rate of economic growth is one third the estimate issued just two months earlier.

At approximately the same time that the Department of Commerce released the GNP figures, the Department of Labor published data on the employment situation. These data indicated that employment grew at an annual rate of between 3.0 percent and 3.4 percent in the first quarter. (The reason for citing a range rather than an actual employment growth figure is that the Department of Labor uses two employment surveys – the household survey, and the business establishment survey – which yield different results.) As a result, comparing first quarter GNP data from the Department of Commerce to first quarter employment data from the Department of Labor yields conflicting conclusions regarding the economy's health. The data from the Department of Commerce turns the good news, more jobs, into bad news – lower productivity, higher unit labor costs, and higher inflation – since employment growth has been five times higher than the increase in output would warrant.

How Important Are The Government's Numbers?

The data issued by the government serve more than just the purpose of satisfying our idle curiosity. Businesses make billion-dollar decisions based on the assumed accuracy of this information. Americans rely on indices issued by the federal government to dictate changes in contracts, wages and salaries, and the amount of money that is distributed to recipients of Social Security and other government benefits. In addition, federal contracts and federal grants to state and local governments are awarded on the basis of the unemployment rate issued by the Department of Labor. These business decisions, in turn, affect the course of the nation's economy. An expanding economy sends the signal to businesses to gear up, i.e., increase employment and investment, while an economy that is contracting will cause businesses to take defensive action.

The reliance on and acceptance of government statistics as the gospel of economic well-being without any critical evaluation, has placed the economics profession in a position that has, perhaps, allowed economists and government statisticians to play fast and loose with the facts. It might also have given them a credibility that may not be warranted, particularly in view of the shaky ground on which many of the estimates stand, and the frequency with which they are revised.

The wide variation in the estimates of growth indicates that while government statistics may be honest, they may not be accurate or reliable. For instance, a large portion of the GNP data are extrapolations and apportionments from benchmark data which are issued once every five years, rendering the data subject to large errors. In addition, over ten percent of the GNP data are imputations, that is, the placing of a monetary value on goods and services that are not even purchased. For example, the largest imputation in the GNP data is for owner-occupied housing. The Department of Commerce calculates a rental value for the two-thirds of Americans who live in their own homes; this rental value then becomes part of the National Income and Product Accounts. Other such imputations include the value of food, clothing, and lodging given to workers as part of their salaries and wages; food and fuel consumed on farms; and, believe it or not, the value of client services, such as free checking, which many banks provide to depositors who keep a minimum balance in their bank account.

Interestingly enough, according to the Department of Commerce, it is these nonmarket transactions that have been growing faster than the market portion of the GNP. Without taking into account inflation, the market value of GNP increased by 25.6 percent from 1980 to 1983, including both goods purchased and the imputed value of goods. However, goods purchased in the market place increased by only 24 percent compared to a 39 percent increase in goods for which a value was imputed.

Errors in measurement and discrepancies between the information distributed by different government agencies affect virtually every economic sector. What follows are some examples of the problems apparent in the data. These affect investment, savings, trade, inflation, and productivity, among other variables.

GNP Data Sending Out Wrong Signals

The major problems relating to data revisions are the changes in the direction of the variables, that is, when initial estimates show a growing economy and subsequent revisions show the opposite. A correct assessment of the direction in which the economy is moving is of paramount importance, since it has a major impact on the development of appropriate government policy. Table 1 presents real GNP data for 1982, showing how misleading government statistics can be. The choice of 1982 is made to prove a point. That was a recession year, and it is during bad economic times that government statistics carry the most weight.

The original data published by the Department of Commerce, would have led policy makers to conclude that, by mid-year, the economy was recovering from recession and that there was no need for corrective action. However, the fourth quarter numbers would have given them cause for concern. The latest revision of 1982 data, published in July 1984, shows that the economy troughed in the third quarter and the fourth quarter was one of recovery.

TABLE 1
QUARTERLY GROWTH IN REAL GNP
(annual rates)

1982 Quarters	Originally Reported	Currently Reported
First quarter	−3.9 %	−4.6 %
Second quarter	+1.7	−0.8
Third quarter	+0.8	−0.9
Fourth quarter	−2.5	+0.5

Source: U.S. Department of Commerce

The $86 Billion Error

The source of much of the discrepancy appearing in the data is not unknown. A confidential memo from the Council of Economic Advisors, reports of which appeared in the national press last month, revealed that the Department of Commerce, the final arbiter of the economy's performance, has ignored price declines in computers. As a result, it has understated the real value of GNP by $86 billion, or almost five percent of the total value of goods and services produced by the U.S. economy. The impact of this change is particularly important during the current period of economic expansion. Correcting the data for this error, shows that the growth rate in 1984 would have been in excess of 3.0 percent compared to 6.8 percent which was actually reported.

More significantly, correcting for this error would increase the amount of investment in producers' durable equipment by 56.7 percent over current estimates. This indicates that the changes in the tax law introduced under the Economic Recovery Tax Act of 1981 (ERTA) had a significantly greater impact than currently estimated. This is the case because the correction would mainly affect the current recovery, which has already resulted in more investment than any previous post-war recovery.

In addition to understating the value of total output, the $86 billion error changes virtually all measures of economic performance including economy-wide productivity, particularly in the manufacturing sector; the value of industrial production; the value of real exports; and, because of the recent increase in consumer demand for computers, real consumer expenditures.

Savings Data Also In Disarray

There also exists a large discrepancy between the measures of savings reported by the Department of Commerce and those reported by the Federal Reserve System. Department of Commerce data on individual savings indicates that consumers saved $156.8 billion in 1984. Federal Reserve data, on the other hand, shows that consumers saved $204.6 billion, a difference of $47.8 billion in total savings, the equivalent of over $500 per household. The significance of this difference is that it may also affect the level of personal income. The Department of Commerce derives its calculation of savings as the difference between total income after taxes and consumer expenditures. The Federal Reserve, however, uses data based on financial assets and liabilities as the basis for arriving at the savings rate. The fact that the Federal Reserve has come to the conclusion that Americans saved 30 percent more last year than the Department of Commerce data would suggest, may indicate that personal income is understated by that amount. Alternatively, it could indicate that consumer spending may be less than the Department of Commerce estimates. Either way it could add up to a $47.8 billion error in calculating total GNP.

Consumer Price Index Outmoded

One of the most closely followed pieces of economic data issued every month is the Consumer Price Index (CPI). Every one percent change in that index costs the government over $2.5 billion in increases in government benefits that are adjusted for inflation. Over eight million people have jobs whose pay scales are directly linked to the CPI. This index is so widely used that it has become known as the "cost-of-living index."

But is it really a "cost-of-living" index or does it fall short of the mark? The CPI is based on a sample of prices of food, clothing, and other goods and services that consumers buy for day-to-day living. Price changes are measured by re-pricing the same market basket at regular time intervals and comparing its aggregate costs. The index currently in use was revised in 1978 and is based on a Consumer Expenditure Survey undertaken in 1972-73. In January 1983, the Department of Labor changed the way in which home ownership costs are measured, replacing the asset price approach then in use with a rental equivalent.

Unfortunately, this approach does not approximate the real world. Most consumers regularly substitute certain goods and services for others. For instance, if the price of steak rises relative to that of ground beef, consumers will buy more hamburger and less steak. There are, however, other indices which account for this substitution. The Department of Commerce publishes the implicit price deflator for personal consumption expenditures (PCE) which is considered to be a more accurate reflection of changes in the "cost-of-living" since it reflects what consumers are purchasing at the present time rather than what they were purchasing a decade ago.

The data in Table 2 indicate that between 1979 and 1984, the CPI increased by over 59 percent compared to the PCE deflator which rose by 48 percent. The use of the CPI, rather than the PCE, as a basis for cost-of-living increases has resulted in a $20 billion increase in the deficit. The issue of the accuracy of the CPI is underscored by a recent report of the General Accounting Office which stated: "The Bureau of Labor Statistics' quality control...[is]...not sufficient to insure the accuracy of the price data used to construct the CPI...."

TABLE 2
COMPARISON OF CHANGES
IN THE CPI AND PCE DEFLATOR
(selected years)

Year	Percent change		Difference
	PCE	CPI	(CPI−PCE)
1979	9.0	11.3	+2.3
1980	10.2	13.5	+3.3
1981	8.7	10.4	+1.7
1982	5.9	6.1	+0.2
1983	3.7	3.2	−0.5
1984	3.2	4.3	+1.1
1979-84 (Compounded)	48.0	59.3	+11.3

Source: Economic Report of the President, February 1985

Balance of Payments Data: Another $80 Billion Discrepancy

Much has been written about the international balance of payments and the balance of trade problems facing this country, however, few people realize that the data should essentially be used as an indicator of direction rather than as an absolute measure. Based on available data, the world experienced a current account "deficit" of $80 billion in 1982. This, of course, is theoretically impossible since, by definition, one nation's (or group of nations') deficit should be another's surplus. If data collection were completely accurate, the world's current account, that is, the amount of money flowing between countries, should net out to zero.

Of course, the temptation exists to blame statistical discrepancies on other countries since they are assumed to lack the statistical prowess of the U.S. But, guess again! The following quote from a Department of Commerce press release shows that our data collection accuracy is no better than any other country's. The report *Summary of U.S. International Transactions—Fourth Quarter and Year 1984*, states: "The statistical discrepancy—errors and omissions in recorded transactions—was an inflow of $30 billion."

What To Do?

The above are only a few of the data-related problems currently identified. It is not an exhaustive catalog nor is it a list of grievances. It is, however, only the tip of the iceberg.

The question of data improvement and data issuance has become paramount because of the number of decisions, private and public, that are based on the data issued by the federal government. Weakness in our statistical base is an impediment to both government and business decision making. The inaccuracies undermine the decision making process for business researchers, marketing researchers, financial analysts, and business organizations in general. Data collection methods which would, at the same time, yield more timely and accurate statistics, and be unobtrusive and not unnecessarily burdensome to the business community, need to be identified.

It is because of the need for improving the timeliness and accuracy of data both, national and international, that the U.S. Chamber of Commerce is engaging in such a project. The goal of the data improvement project is to improve the accuracy of data collection not only in this country, but worldwide, in order to allow analysts to better interpret the various changes in the global economy which have emerged in the last 40 years.

TRENDS IN COMMERCE
NOTES ON TABLE II
JUNE, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—The Department of Commerce's revised estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—indicates that the inflation-adjusted growth rate slowed to a seasonally adjusted annual rate of 0.7 percent in the first quarter. This is about one-half the 1.3 percent growth rate estimated in April. The data continues to indicate that the consumer and business sectors increased spending in the first quarter, but much of the increase in demand was met from an 11.3 percent rise in imports rather than from increases in domestic production.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.5 percent in April, the same as in March. The money supply in the latest three-month period has been growing at an 8.6 percent seasonally adjusted annual rate, above the Federal Reserve target range for money growth.

Employment—The civilian unemployment rate remained unchanged at 7.3 percent in May for the fourth month in a row. Civilian employment—as measured by the monthly survey of households—increased by 15,000 persons (seasonally adjusted), to 107.0 million, bringing the employment increase in the last twelve months to nearly two million. In contrast, the number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 345,000 in May. This increase reflects the continued strength of service sector and construction employment.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.4 percent in April, following a 0.5 percent rise in March. Over half the April increase was due to increases in gasoline and fuel oil prices. Gasoline prices in April rose 3.1 percent, following a 3.6 percent increase in March, bringing the two month rise in gasoline prices to 6.8 percent. However, prices for food purchased for home consumption declined for the second month in a row.

Wholesale prices of finished goods rose 0.3 percent in April, following a 0.2 percent increase in March. This marks the first back-to-back monthly increases in finished goods prices in over a year. The increase in finished goods prices, at the wholesale level, resulted mainly from one month increases in gasoline prices of 9.5 percent and in the price of home heating oil of 10.2 percent. From April 1984 to April 1985 the finished goods index increased only 0.7 percent.

The more volatile part of the Producer Price Index, crude goods, declined by 1.2 percent in April, following decreases of 1.9 percent and 1.5 percent, respectively, in February and March. Crude materials prices in April were 8.3 percent below their levels of a year ago. Weak crude material prices appear to be a product of the strong dollar, and a surplus of farm products. Crude food and feedstuffs prices have declined nearly 10 percent since the start of the year.

Housing Starts—Privately-owned housing units started in April reached 1,913,000 units (seasonally adjusted annual rate), the best level for any one month in a year. The surge in housing starts was mainly the result of the decline in interest rates which has lowered the cost of home ownership and increased the affordability of new homes. Although new single-family home sales fell by 11.9 percent in April, existing home sales maintained a strong pace, inching up to a three million unit rate.

Industrial Production—Industrial production declined 0.2 percent in April, following three consecutive months of increases. Production decreases were apparent in most major categories of manufactured goods. The only increases registered in April were in defense and space products,and construction supplies. Production of consumer goods fell by 0.4 percent, this was due mainly to a 1.2 percent decline in automotive products and a 0.8 percent decline in home goods. Business equipment production also declined 0.3 percent in April, the fourth consecutive decrease, but remained over eight percent above the level of April 1984.

The capacity utilization rate for manufacturing decreased 0.5 percentage points in April as factories operated at 80.5 percent of capacity. The sectors suffering the largest declines in utilization were electrical machinery and motor vehicles and parts. Manufacturing capacity increased 0.8 percent in the first quarter of 1985, 3.1 percent above the first quarter of 1984.

Productivity—Nonfarm business productivity fell at a 2.5 percent annual rate in the first quarter, compared with a preliminary estimate of 1.2 percent. The decline was the most drastic since the fourth quarter of 1981, when it dropped 4.4 percent. The productivity decline resulted from an increase in jobs of over 800,000 in the first quarter (which amounts to a three percent annual rate of growth in employment), while the economy was growing at a 0.7 percent annual rate. The revision in the productivity number can also be attributed to the downward revision of the GNP data. Output was essentially flat while hours worked by employees increased at an adjusted 3.3 percent rate, the biggest jump since the second quarter of last year. The combined effect of employees' working longer hours and producing less caused unit prices in the nonfarm sector to soar at an adjusted annual rate of 8.1 percent.

Interest Rates—At ten percent, the prime interest rate is three percentage points below last summer's peak, and at the lowest level since October 1978. The reduction in the prime rate reflected the lower cost of funds to the banks and is not an indicator of future trends in interest rates. Rates fell on all maturities, but the largest decline was in the yield for one-year securities, which fell 30 basis points to 8.02 percent. The cost of short-term funds to the banks, as represented by the federal funds rate and the average interest rate on 90 day Certificates of Deposit, has fallen by between 3.5 and four percent since the summer of 1984, which may indicate that the prime has still further to fall.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicates that business failures continued to rise in mid-April and were almost four percent above the level of a year ago. The index of business failures, which uses October 1983 as a base of 100, increased to 109.4 in the week ending April 19, 1985, the highest level of 1985. This was eight percent above the business failure index reported a year ago. The business discontinuances index was 18 percent above the year-ago level. The recent rise in business failures is largely the result of an increase in agricultural failures.

The latest available data indicates that there were 583,147 new business incorporations in the first eleven months of 1984, a 6.3 percent increase over the same period in 1983. The continuation of the current trend would result in over 635,000 new business corporations having been formed in 1984, an increase of 35,000 from the previous year. The number of new business corporations formed in November 1984 was 53,490 (seasonally adjusted), 3.6 percent more than the same month a year earlier. New business incorporations increased rapidly in the first six months of 1984, but actually declined in the third quarter. The data for October and November indicate a resumption of growth in the number of new corporations formed in the first two months of the fourth quarter. Seventeen states registered increases of more than 10 percent from their year-ago levels in November, with Louisiana, South Carolina, and Georgia reporting the largest increases.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, rose by 19.7 percent in April compared to its year-ago level. In the first seven months of fiscal 1985, federal expenditures increased by 12.2 percent, three times as fast as prices, indicating a real increase in federal spending of about eight percent from the year-ago level. Federal receipts, during the same period, have increased by 13.1 percent as a result of increases in personal income taxes, corporate income taxes and social insurance taxes. Receipts for the month of April were up 17.8 percent from the same month a year ago, partially as a result of a more than 35 percent increase in final settlements for taxes owed for calendar year 1984. The federal government deficit in the first seven months of fiscal 1985 is $118.9 billion, over $10 billion more than in the comparable period of 1984. In addition, delays in mailing out tax refunds will add nearly $6 billion to the deficit because the Treasury must pay interest on refunds processed after June 1st. The continued growth of the deficit, despite the double digit growth of federal receipts, indicates that the deficit is the result of excessive growth in federal outlays rather than the result of tax cuts.

Personal Savings—According to Department of Commerce data, personal savings declined to 4.6 percent of after-tax income in the first quarter of 1985, from 6.2 percent in the fourth quarter of 1984. The reason for the decline in the savings rate appears to be directly related to the delay in mailing out tax refunds, which consumers normally rely on at this time of year. The delays in the refunds reduced after-tax income by $6.7 billion in February and March, which when translated into seasonally adjusted annual rates, amounts to over $40 billion, on average, for each of the two months.

Retail Sales—Sales at the retail level jumped 0.9 percent in April, following a 0.7 percent decline in March. April retail sales were 4.5 percent higher than their year ago level. The big gains were reported by department stores showing a 1.9 percent increase, and auto dealers with an increase of 1.7 percent. In real terms, retail sales are running nearly 5 percent ahead of a year ago.

Trade Deficit—The trade deficit, on a goods and services basis, increased to $73 billion in the first quarter. The deterioration is the result of a $5.8 billion decrease in first quarter exports while imports continued to increase by $11.2 billion. The merchandise trade deficit rose by $800 million in April to $11.9 billion, the largest increase in a year. The increase in the April merchandise trade deficit was the result of a 3.6 percent decrease in the value of exports and a 0.5 percent rise in imports. The April increase in imports was attributed to increases in oil imports and a 25 percent increase in the number of Japanese cars imported following the lifting of the voluntary restraint program on car imports.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, decreased 0.2 percent in April, with six of the ten available indicators down. The decline follows an upwardly revised increase of 0.1 percent in March. The index of coincident indicators, a monthly approximation of aggregate economic activity, rose 0.1 percent in April, following a 0.4 percent gain in March.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Mar/85	238.3	238.1	236.1	0.1	0.9
Gross National Product ($B) [a]	I/85	3,817.1	3,758.7	3,553.3	1.6	7.4
Gross National Product (72$B) [a]	I/85	1,665.4	1,662.4	1,610.9	0.2	3.4
Money Supply (M1) ($B) [a]	Apr/85	575.0	572.1	539.2	0.5	6.6
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Apr/85	2,446.3	2,449.4	2,310.1	0.7	6.8
Personal Consumption Expenditures (72$B) [a]	Mar/85	1,087.3	1,093.5	1,039.1	-0.6	4.6
Disposable Personal Income ($B) [a]	Apr/85	2,717.2	2,640.6	2,543.5	2.9	6.8
Disposable Personal Income (72$) [a]	Mar/85	1,172.2	1,180.6	1,151.8	-0.7	1.8
Personal Savings Rate (%)	Mar/85	4.6	4.5	6.5	0.1[b]	-1.9[b]
Civilian Employment (millions) [a]	May/85	107.0	106.9	105.2	0.1	1.7
Civilian Unemployment Rate (%) [a]	May/85	7.3	7.3	7.8	0.0[b]	-0.2[b]
Average Hourly Earnings [a]	Apr/85	$8.54	$8.50	$8.25	0.5	3.5
Consumer Price Index (All Urban, 67=100)	Apr/85	318.8	317.4	307.4	0.4	3.7
Purchasing Power of the Dollar (67=$1.00)	Apr/85	0.312	0.313	0.323	-0.4	-3.5
Prime Interest Rate (%) May 31, 1985		10.0	10.5	12.5	-0.5[b]	2.5[b]
Retail Sales ($) [a]	Apr/85	112.2	111.3	107.4	0.9	4.5
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	I/85	224.2	228.7	243.3	-2.0	-7.9
After Tax	I/85	140.0	141.0	150.6	-0.7	-7.0
Industrial Production (67=100) [a]	Apr/85	165.4	165.8	162.1	-0.2	2.0
Capacity Utilization Rate (Mfg.) (%)	Apr/85	80.5	81.0	81.3	-0.5[b]	-0.8[b]
New Housing Starts (thou. units) [a]	Apr/85	1,913.0	1,883.0	1,949.0	1.6	-1.8
Net Business Formation (67=100)	Apr/85	115.1	115.2	117.5	-0.1	-2.0
New Business Incorporations (Thousands) [a]	Nov/84	53.5	52.6	51.6	1.7	3.6
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100) [a]	I/85	163.2	160.0	158.3	2.0	3.1
Unit Nonlabor Costs (77=100) [a]	I/85	160.9	160.3	152.2	0.4	5.7
Producer Price Indices (67=100)						
Crude Materials [a]	Apr/85	307.7	311.5	335.4	-1.2	-8.3
Intermediate Goods [a]	Apr/85	319.1	318.4	320.1	0.2	-0.3
Finished Goods [a]	Apr/85	293.6	292.7	291.6	0.3	0.7
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100) [a]	Apr/85	626.1	594.4	523.0	5.3	19.7
Federal Government Debt Outstanding ($B)	Dec/84	1,667.4	1,635.5	1,415.3	2.0	17.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	I/85	363.5	367.2	358.9	-1.0	1.3
Imports of Goods & Services ($B) [a]	I/85	432.6	423.2	410.4	2.2	5.4
Balance on Goods & Services ($B) [a]	I/85	-69.1	-56.0	-51.5	23.4	34.2
WHAT'S AHEAD?						
Index of Leading Indicators (67=100)	Apr/85	167.4	167.7	168.1	-0.2	-0.4

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

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OUTLOOK

Chamber of Commerce of the United States
July/August 1985

TAX REFORM

by
Richard W. Rahn

The following are excerpts from testimony presented before the House Committee on Ways and Means on June 26, 1985.

Americans from all walks of life support tax reform because they believe that it will enhance their material well-being by eliminating onerous provisions and creating opportunity for economic advancement. Absent these objectives, however, tax reform would be an unproductive exercise, the cost of which, both in political and economic terms, would vastly outweigh the benefits.

In the context of reforming a body of law as complex as our tax code, economic opportunity is a rather amorphous objective and, as such, requires the formulation of more specific standards. Such a standard can be operationally defined by reducing the goal of economic growth into its component parts and using these as the basis for measuring the desirability of any reform proposal. For the purposes of our evaluation, we have selected the following contributors to growth as the key standards by which to evaluate any tax reform proposal: (1) capital formation; (2) technological advancement; (3) international competitiveness; and (4) job creation. It is our belief that any tax reform proposal which does not enhance the prospects of each of these objectives is a costly exercise with limited benefits to the American people.

In our view, the Administration's tax reform proposal improves our present system but does not take that extra step which would make the package a truly growth-inducing set of reforms. Indeed, most of the analyses performed to predict the impact of the tax plan, including the Treasury's own projections, indicate that the package, as presently constituted, only moderately advances economic growth beyond what is expected under current law.

The goal of tax reform should be to reach a growth path for real gross national product that is at least one percentage point higher than what would otherwise occur. With the unemployment rate slightly in excess of seven percent, with inflation under control, and with industry operating at about eighty percent of capacity, we believe that this goal is feasible. A well-constructed package of tax reforms, combined with spending restraint and stable monetary policy, could easily achieve it.

The tax law affects each of the determinants of economic growth mentioned above. Capital cost recovery allowances affect the cost of capital and, therefore, the level of investment in plant and equipment. Capital gains tax rates also affect the cost of capital as well as the after-tax reward to risky activities, such as research or the launching of new products or enterprises. Consequently, the tax treatment of capital gains has strong effects on the level of investment and the degree of technological innovation. Marginal tax rates influence the cost of capital, the after-tax return to additional work, and virtually every other economic activity. Lower marginal tax rates will raise the incentive to invest and to work. The tax treatment of international business, in particular, of income earned abroad, has an important impact on the competitiveness of U.S. business. Finally, the tax treatment of savings has important effects on the level of saving and the capital available to sustain high rates of economic growth.

CAPITAL FORMATION

Capital Cost Recovery

For many years, capital investment had been singled out for unfavorable tax treatment. While most business

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expenses were deductible in the first year, capital expenses had to be deducted over a number of years without adjustment for inflation and the opportunity cost of money. Since the tax code ignored this "time value of money," it was biased against long-term investment.

Requiring capital costs to be recovered over a long period of time, without adjustment for the time value of money, increases the after-tax cost of the machine or structure being purchased. Adverse tax treatment forces investors to require a higher before-tax return from depreciable property in order to receive the same after-tax return. Consequently, capital investment is less attractive, investment declines and productivity and economic growth are reduced.

The Accelerated Cost Recovery System (ACRS), a cornerstone of the Economic Recovery Tax Act of 1981 (ERTA), was a first step towards increasing investment incentives. Replacement of the inadequate Asset Depreciation Range (ADR) system with ACRS reduced the cost of capital and spurred an unprecedented surge in investment in plant and equipment which made a major contribution to the strength and duration of the recovery we are now experiencing. ACRS, combined with the investment credit, is approximately equivalent to expensing in present value terms, i.e. when one takes into account the time value of money and inflation. The combination of ACRS and the investment tax credit successfully reduced the tax bias against investment.

The Administration's plan is but one of many tax reform proposals which have been introduced. Unfortunately, several of these proposals constitute a step backwards from the progress achieved through ACRS. They would reduce capital cost recovery allowances for equipment and would harm certain types of investment. Table 1 shows the effect of the various proposed capital cost recovery plans on the after-tax cost of capital. The table reflects the effect of corporate tax rate reductions, dividend deductibility, the investment tax credit and depreciation allowances. From it we see that the Administration's proposed capital cost recovery system (CCRS) would substantially raise the cost of capital for equipment. Increased capital costs will reduce investment and harm economic growth. (For a detailed discussion of this issue, see *Capital Cost Recovery and Tax Reform*, ECONOMIC OUTLOOK, April 1985).

Windfall Tax on Excess Depreciation

The Chamber is concerned about the economic effects of the Administration's proposal to recapture "excess" depreciation with a windfall tax. The Administration argues that taxpayers who have benefited from accelerated depreciation deductions would experience a windfall gain as a result of the proposed reduction in the corporate tax rate from 46 percent to 33 percent. This proposal would tax income earned from investments made between 1980 and 1985 at a 46 percent rate, and only income earned from investments made after 1985 would enjoy the lower, 33 percent, tax rate.

TABLE 1
COST OF CAPITAL UNDER VARIOUS RECOVERY METHODS

Capital Cost Recovery System	Inflation = 5% Real Discount Rate = 4%	Inflation = 8% Real Discount Rate = 5%	Change in Cost of Capital Compared to Current Law
ACRS-ITC 3 YEAR[a]	1.00	1.03	–
ACRS-ITC 5 YEAR[a]	0.99	1.04	–
ACRS 18 YEAR[a]	1.36	1.44	–
NCRS 4 YEAR[b]	1.01	1.02	+ 1
NCRS 6 YEAR[b]	1.01	1.04	+ 2
NCRS 25 YEAR[b]	1.05	1.15	– 23
SCRS 6 YEAR[c]	1.05	1.07	+ 5
SCRS 18 YEAR[c]	1.15	1.18	+ 16
SCRS 40 YEAR[c]	1.24	1.27	– 9
RCRS 5 YEAR[d]	1.02	1.03	+ 2
RCRS 17 YEAR[d]	1.08	1.09	+ 9
RCRS 63 YEAR[d]	1.20	1.22	– 12
CCRS 4 YEAR[e]	1.01	1.02	+ 1
CCRS 7 YEAR[e]	1.05	1.06	+ 6
CCRS 28 YEAR[e]	1.20	1.23	– 12
Expensing	1.00	1.00	–

[a] Present law.

[b] NCRS is the Neutral Cost Recovery System embodied in the Kemp-Kasten proposal which provides the present value equivalent of expensing.

[c] SCRS is the Simplified Cost Recovery System embodied in the Bradley-Gephardt proposal. SCRS employs lives similar to the old ADR class lives but allows a 250% declining balance method.

[d] RCRS, the Real Cost Recovery System, was originally proposed by the Treasury Department in November 1984.

[e] CCRS, the Capital Cost Recovery System, is embodied in the President's latest tax reform proposal.

The concept of windfall gains and losses would have some validity if the only tax code change proposed were the reduction in the corporate tax rate from 46 percent to 33 percent. The President's proposal, however, contains a number of other changes which are likely to offset gains from the rate reduction. Furthermore, no consideration is made under the proposal for losses due to the repeal of capital gains treatment for depreciable property and section 1231 property. It is not fair to apply the windfall gains tax only to capital investment without some compensation for the windfall losses brought about by other provisions in the reform proposal.

Dr. Richard W. Rahn, Vice President and Chief Economist.
Dr. Ronald D. Utt, Deputy Chief Economist.
Ms. Graciela Testa-Ortiz, Director, Forecast Section.
Mr. Martin Lefkowitz, Director, Economic Trends and Statistics.
Dr. William Orzechowski, Director of Federal Budget Policy.
Ms. Rajni Bonnie Ohri, Economist.

The Chamber believes the windfall tax on excess depreciation will have detrimental effects on the economy. Cash flow problems will result from windfall tax payments by those companies with older investments, leaving less capital available for new investment. Reduced new investment will cause a business slowdown, especially during the three year period when the windfall tax provision is in effect. Considering that the cost of capital will be increased as the result of other changes in the proposal, the addition of the windfall tax is an excessively unfair burden on capital investment.

The Double Taxation of Corporate Dividends

The Chamber commends the Administration's proposal to provide a 10 percent deduction for dividends paid by corporations. Corporate dividends are taxed twice because corporations pay taxes on their profits, and then shareholders must pay taxes again on their dividends. This double taxation of income reduces the amount of capital available for investment and is both unfair, and destructive to economic growth. Double taxation of income encourages firms to retain earnings rather than pay profits out as dividends. It thus reduces the liquidity and efficiency of capital markets; further, it encourages concentration of business and discourages the development of new enterprises.

Capital Gains

Evidence from the 1978 and 1981 reductions in the capital gains tax rate show that both investment and federal revenues rose substantially. In 1978, the capital gains tax rate was reduced from 49 percent to 28 percent. In 1981, it was further reduced to 20 percent. These reductions in the tax rate contributed to a $2.5 billion increase in federal revenues and raised the proportion of total taxes borne by the wealthy. If we assume, as is almost certainly the case, that those with adjusted gross incomes over $500,000 are in the maximum tax bracket, then capital gains taxes paid by the wealthy were $1.8 billion in 1978 and $4.2 billion in 1981. This constitutes a 130 percent increase in tax revenues. (For a detailed discussion of this issue, see *Boosting Capital Formation and Tax Revenues: The Case of Capital Gains Tax Reduction*, ECONOMIC OUTLOOK, June 1985). In view of these results the Chamber strongly endorses further reduction in the capital gains tax rate as proposed in the Administration's tax reform plan.

Reduced Marginal Tax Rates

The marginal tax rate is the rate of tax a taxpayer will pay on the next dollar he earns. A taxpayer's average or effective tax rate, in contrast, is the sum of taxes he pays divided by his total income. The economically more relevant tax rate is the marginal tax rate. When making the economic decision whether to work an extra hour, a taxpayer is concerned with the degree to which the extra income will be taxed. He will not concern himself with how much tax he paid on his first $1,000 of income.

As marginal tax rates increase, so do the disincentive effects of taxation. A tax on work (employment income) makes work less attractive relative to leisure, causing many people to choose to work less. Similarly, taxes on savings (investment income) raise the price of savings relative to consumption and cause people to substitute towards present consumption. The price of consuming now is the amount of investment income foregone by the consumer (i.e., interest the money spent could have earned if deposited in the bank instead). A tax on investment income reduces the amount of after-tax income foregone and consequently makes present consumption relatively more attractive. Therefore, further reductions in marginal tax rates will raise incentives to work, save, and invest.

The Mellon tax cuts (1921-23), the Kennedy tax cuts (1963-65) and the Reagan tax cuts (1981-84), proved that reducing marginal tax rates buoys economic activity and raises tax revenues. Proponents of these rate reductions argued that they would encourage work, savings, and investment, and would lure the rich out of tax shelters and into taxable investments. In the long run, the tax cuts, by increasing the return to capital and labor could also lead to robust economic growth, an even greater expansion of the tax base and more economic benefits for everyone.

The results for 1982 and 1983 show emphatically that incentives do matter. The percentage of taxes paid by higher-income groups has increased, while that paid by lower-income individuals has actually fallen. Although ERTA reduced the top tax rate from 70 percent to 50 percent, individuals earning over $1 million in annual income paid 37 percent more in taxes in 1982, a recession year, than they did in 1981. Similarly, those earning between $500,000 and $1 million annually paid 25 percent more taxes in 1982 than in 1981. By 1983, those earning over $1 million paid 102 percent more in taxes, and those earning between $500,000 and $1 million paid 47 percent more.

Equally as fascinating is the fact that the relatively well-to-do paid a larger share of the total tax burden after the enactment of ERTA than before. Between 1981 and 1982 the tax burden of those earning over $1 million increased by about 40 percent, and the tax burden of those earning between $500,000 and $1 million increased by 25 percent. By 1983, each group was bearing almost twice as much of the overall tax burden as they were before ERTA. In fact, only those earning below $50,000 per year actually paid a smaller portion of the total tax burden the first year after ERTA was enacted.

Even partisans of big government should favor the Reagan, Kennedy and Mellon tax rate reductions for upper income taxpayers. Those tax cuts raised more money for the government to spend. We have not examined, however, the enormous cost of high tax rates to the broader public. Both those paying taxes and those hoping to have enough income that they must pay taxes are forced to bear the burden of a stagnant economy, devoid of hope and opportunity. Low rates of economic growth have been thrust upon the American economy by those who would rather assuage their conscience by angry rhetoric and misguided attempts to punish the rich when America could have an economy sufficiently dynamic to improve everyone's living standard.

Tax Reform and Savings

As is to be expected, the tax treatment of savings affects the level of savings in the economy. Individual Retirement Accounts (IRAs), Keogh retirement plans, 401(k) savings plans, and the tax treatment of corporate pensions all reduce the tax bias against savings in the United States. Because these provisions reduce or eliminate the tax wedge between the before- and after-tax return to savings, savings rates are not reduced as much as otherwise would be the case under an income tax system.

The Administration's proposal would basically maintain the present treatment of retirement savings. The proposal to expand IRAs by increasing the spousal IRA amount to $2,000 would improve the savings rate. The proposed limitation on contributions to 401(k)s and defined contribution plans would tend to reduce savings. As a result, the plan's overall effect on savings is ambiguous.

The Administration has proposed disallowing employees of nonprofit organizations and state and local governments to benefit from the use of section 401(k) plans. Not only is there no economic justification for proposals to limit 401(k) plans, but also, such a proposal would discriminate against workers who are not offered retirement plans as favorable as many workers in private industry.

TECHNOLOGICAL ADVANCEMENT

The Chamber applauds the Administration's proposal for including the three-year extension of the research and development tax credit. Since it was enacted in 1981, this tax credit has stimulated research and development in the U.S. Extension of the credit will spur greater technological advancement, improve the international competitiveness of U.S. industries, and create new jobs.

Since at least the late 1960s, the United States has led the free world in terms of the proportion of total output devoted to both public and private research and development. In recent years, however, our lead has substantially narrowed. Research expenditures are a crucial element in improving our ability to compete abroad. A report released in February 1985 by the Brookings Institution and Data Resources, Inc. documents the role of industrial research in fostering economic expansion and international competitiveness. Prior to the enactment of the R & D credit, the U.S. devoted the smallest share of GNP to private industry research of any industrial nation. After the credit was enacted in 1981, the gap began to close.

A permanent research credit would offer the stable and predictable tax policy necessary to successfully compete internationally. The Brookings/DRI report provides a range of quantitative estimates of the economic benefits of a permanent credit. The most conservative estimate shows that, upon enactment of the permanent credit, GNP would rise by $1.2 billion in 1986 and $2.9 billion in 1991. "Best case" estimates show increases in overall economic activity as high as $7.5 billion in 1986 and $17.7 billion in 1991.

Investment in research is, by nature, a long-term proposition. If we are to achieve our goals of capital formation, technological advancement, international competitiveness, and job creation, research expenditures must be conducted at high levels for many years. A stable and predictable tax policy is necessary for such expenditures to continue. Consequently we recommend making the research credit a permanent feature of the tax code.

We also recommend that the Congress retain provisions in the tax code that allow research expenditures to be expensed. Research expenses, like other expenses, should be deducted in the year incurred rather than amortized over long periods. Only expensing, as under present law, eliminates the tax bias against investment in research.

INTERNATIONAL COMPETITIVENESS

The Chamber is greatly concerned with the effect of tax reform on international competitiveness. U.S. businesses presently face difficult obstacles in competing with foreign firms. These obstacles are the result of the high value of the dollar, tariff and nontariff barriers to U.S. firms entering overseas markets, and foreign government subsidization of industry. A number of provisions in the Administration's tax reform proposal would exacerbate these problems.

Proposals that increase the cost of capital will lead to higher prices on U.S. products making them less competitive with foreign-made goods. The increase in the cost of capital could also cause U.S. firms to fail to invest in more technologically advanced processes, and as a result, make U.S.-produced goods relatively less competitive. Moreover, there is strong reason to believe that inadequate capital cost recovery allowances could cause U.S. businesses to locate their manufacturing plants abroad where the tax treatment of investment is more favorable.

In addition to the capital formation provisions, several of the international tax aspects of the proposal will also affect the ability of U.S. firms to compete internationally.

Foreign Tax Credit

The Administration has proposed calculating the foreign tax credit limitation on a per country basis, rather than under the overall method currently in use. The U.S. rules for calculating the foreign tax credit are designed not only to prevent double taxation of foreign source income but also to limit the credit to U.S. tax imposed on income earned and taxed overseas. The credit is designed so that it does not reduce U.S. tax on income earned from operations in the United States. This is true whether or not an overall limitation or a per country limitation is used.

The overall limitation permits averaging of taxes paid in high-tax countries with those paid in low-tax countries. Although Treasury may regard averaging as a potential abuse, averaging of *bona fide* foreign taxes imposed on foreign source income is a proper attribute of a foreign tax credit. This is true because within the context of global business operations, averaging is a realistic way of dealing with the complexities of international trade where business is ordinarily conducted on an integrated rather than a per country basis. Averaging mitigates the mismatching that is often caused by the different rules that exist between countries for determining the tax base and the timing of income and deductions. Most countries that avoid international double taxation either use an overall limitation (as does Japan), exempt direct investment income, or use a per country limitation that permits a form of averaging and bears no resemblance to the more exacting per country method proposed by the Administration. Thus, adoption of a per country limitation, as proposed by the Administration, would cause U.S. companies to be subject to greater double taxation of foreign income relative to their foreign competitors.

Companies do not organize strictly on a country-by-country basis. A German manufacturing subsidiary of a U.S. company may well develop technology that it licenses to a Dutch or Japanese enterprise and will sell its products throughout Europe, Africa, and perhaps elsewhere, doing so through branches or sub-subsidiaries. The averaging effect of the overall method is consistent with the approach normally taken by U.S. businesses in making investments abroad, that is, to serve broad geographic markets which may involve production, transportation, and marketing facilities in several different countries.

As is stated above, the Administration's per country proposal would put U.S. businesses at a competitive disadvantage when compared to the foreign tax credit rules used by our trading partners. Our major trade rival, Japan, has an overall limitation. Additionally, Japan has a network of tax sparing treaties, which allow Japanese firms to credit the tax foregone by the host country against tax liability to Japan. When combined with the use of the overall limitation, this provides Japanese companies a credit for taxes that were never paid. The Japanese system provides Japanese business with a tax advantage over the United States even under current law, which would be greatly exacerbated if the Administration's per country proposal were adopted.

Canada, France and Germany employ a mixed system which primarily relies upon exemption (under treaty or by statute), and permitting foreign tax credits under the per country method where exemption does not apply. However, in those countries using a per country method, including the United Kingdom, a form of averaging is permitted through the use of third country holding companies.

Thus, the per country proposal would lead to an increase in the overall effective tax rate on foreign source income of U.S. businesses and decrease U.S. competitiveness. Foreign investment and operations by U.S. businesses provide significant benefit to the U.S. economy in the form of jobs, increased exports, and tax revenue. At a time when the President's Commission on Industrial Competitiveness has called for the elimination of practices that are impeding the ability of U.S. companies to keep pace with the "new reality of global competition," Treasury proposes to introduce a new barrier to the penetration of foreign markets: the per country limitation.

Sourcing Rule Changes

Our tax laws define the source, foreign or U.S., of income and expenses for the purpose of defining the scope of U.S. taxation and where primary jurisdiction for taxation of U.S. citizens is conceded to a foreign country because income is deemed to be earned in that country. The source of income and expenses of U.S. taxpayers becomes part of the formula for determining the amount of the foreign tax credit allowed to U.S. taxpayers for taxes paid to foreign jurisdictions because the credit is allowed only to the extent foreign taxes are paid on "foreign source" income.

The proposed changes with regard to the sourcing rules for sales will directly increase the tax on income earned from export sales. Last year the Administration proposed and Congress enacted the Foreign Sales Corporation provisions because they recognized the importance of encouraging U.S. exports given the size the U.S. trade deficit. Yet, the proposals to change the source of income rules as applied to export transactions substantially undercut that effort without any analysis of the impact such a change might have on U.S. trade. Indeed, the obvious effect of this proposal would be to either (1) increase the tax on U.S. exports, or (2) force exporters to establish more fixed places of business outside of the United States. We query whether our national policy should be to do either.

JOB CREATION

Since November 1982, when the economic recovery began, American business has created nearly 8 million jobs. Of these, 66 percent were created by small businesses who are playing an increasingly significant role in our economic success. The Chamber applauds the interest the Administration has shown regarding the impact of this tax proposal on small business. We must ensure that these companies do not receive a major tax increase under any tax reform plan adopted. The retention of the graduated rates, which is part of the Administration's proposal, is an essential ingredient of any plan.

As over 80 percent of small businesses are unincorporated, the reduction in the tax rates for individuals will greatly benefit them. Reductions in corporate and individual tax rates will provide more capital for business expansion, thus leading to the creation of more jobs and to greater economic growth. It is crucial to the economic success of this country that once the base is broadened in exchange for lower rates, that these rates not be raised later.

The differential between capital gains and ordinary income tax rates is also important to maintain. The retention of a capital gains rate helps to make venture capital available to businesses for expansion. The availability of venture capital is particularly important to small businesses who have a very difficult time attracting sufficient financing.

Because payroll taxes have a direct effect on the cost of labor, we are concerned about proposals to tax workers' and unemployment compensation. Since each state sets maximum benefit levels for both workers' and unemployment compensation, taxation of these benefits (at the federal *and* state and local level, since most state taxation policy mirrors that of the federal government), will require increases in outlays to offset such taxation solely to maintain current, net benefit levels. The federal government has its own workers' and unemployment compensation programs, and benefits under these programs would also face similar outlay increases to maintain current, net benefit levels. The increased benefit levels would be funded through increased payroll taxes, in the case of unemployment compensation, and increased premiums in the case of worker's compensation. The resulting increase in the payroll tax burden will affect an employer's decision to hire additional workers, especially in the case of small businesses for whom the payroll tax cost of hiring workers plays a significant role in employment decisions. Increasing the payroll burden on employers (and, in turn, the ultimate cost to consumers of goods and services) will decrease the incentive to expand employment and exacerbate the ability of U.S. firms to compete abroad.

Employee Benefits

The U.S. Chamber supports the development and maintenance of a strong, voluntary, nondiscriminatory, private sector employee benefits system, which can vary in accordance with the needs of employers and employees. Accordingly, proposals to subject employee benefits to taxation and further regulation are of concern to us.

The Reagan Administration had been correctly committed to reducing the incidence of government intrusion in the marketplace. Its goals of privatization and deregulation of certain government services are shared and supported by the Chamber. However, new rules regarding distribution and nondiscrimination requirements for employee benefit plans would be inconsistent with these goals.

Incentives for business to offer health and insurance benefits to employees reduce the utilization of, and pressure on government-provided services. Reduced regulation and taxation of employee benefit plans would reduce business costs and allow greater flexibility in choice of benefits for workers. The Employee Benefit Research Institute estimates that the $100 billion worth of health coverage provided by employers to some 82 million workers costs the government less than one-third of that amount in foregone taxes. The replacement cost of similar health protection provided directly by the government would be the full $100 billion.

The Chamber encourages continued efforts toward privatization alternatives to government programs, such as individual retirement accounts and Keogh plans. Increased privatization will reduce reliance on the already overburdened Social Security system and provide better returns on worker investment.

Under the proposed changes, however, many currently tax-qualified retirement plans will not maintain that status, and numerous businesses – especially small businesses – will be discouraged from establishing retirement savings plans due to their increased administrative complexity. As a result, the Social Security system may be called upon to provide a greater proportion of retirement security.

In short, employer provided benefits are serving an important function more efficiently and at a lower cost than the public sector could meet the challenge. New rules on the operation of benefit plans are contrary to the objectives of fairness and simplicity in the tax code and cause extreme problems for small business.

CONCLUSION

The Chamber commends the President on his tax reform package. It is a positive step towards the much needed reform that this country awaits. In 1981 President Reagan started down this path by supporting the changes included in the Economic Recovery Tax Act (ERTA). The economic response to ERTA is unsurpassed. Investment and GNP are rising, interest rates and inflation are low and declining and productivity has improved. However, the Administration's proposal must be improved to assure that it enhances economic growth in order to continue the spurt in the economy begun by the 1981 changes.

Congress now has the tremendous opportunity to design a tax reform plan which will continue to increase economic growth. The benefits of a dynamic economy flow to all Americans. But a growing economy is most fair to the least advantaged Americans, those that most need the improved living standards that only a growing economy can provide. To increase capital formation and enhance job creation, the Congress should improve the proposal's capital cost recovery system so it is equal to, or better than, present law. International competitiveness must not be impaired by our tax code. As written, the foreign tax credit provisions of the proposal would lessen the ability of American businesses to compete abroad.

The Chamber applauds the proposal's support of technological advancement by the retention of the R&D credit. The reduction in capital gains tax rates will spur capital formation and reduce the tax bias against risk-taking. Reduced corporate and individual tax rates will increase the incentive to work, save and invest thereby increasing economic growth.

Never has this country been more ready for a sweeping change to our tax system. Support for tax reform is bi-partisan. Tax reform, properly conceived and executed, can fuel an unprecedented economic expansion. In crafting such a sweeping change in the tax system, Congress should provide for reasonable and fair transition rules so as not disrupt normal business activity.

MONETARY POLICY KEY TO SUSTAINING ECONOMIC GROWTH

by
Ronald D. Utt

Despite the recent report that second quarter GNP growth advanced at an unexpectedly strong 3.1 percent, there remain pervasive doubts about the prospects for the remainder of the year. In support of the pessimistic view is the seemingly endless stream of bad news from the many monthly and weekly reports on various segments of our economy. Industrial production has been flat since late last year and may not improve much in the near term as a result of the growing penetration from imported goods. In May, the merchandise trade deficit rose to $12.7 billion, the second highest on record. The deficit was carried to that level by the second highest monthly level of merchandise imports. With the economies of our major trading partners continuing to stagnate and with the dollar still highly valued, substantial import pressures will persist for the rest of the year.

The housing sector presents a mixed picture, although it should be doing much better considering the sharp drop this spring in mortgage interest rates. Total housing starts fell by 14 percent in May to 1.7 million units from an impressive 1.9 million in April. Sales of new single family homes rose 10 percent in May, the highest reported increase since March 1984, but sales of existing homes fell in the same month. As for business fixed investment, planned expenditures on new plant and equipment for 1985 are slowly sinking with each successive survey. In real terms, spending on plant and equipment is expected to rise 6.2 percent this year, down from the 7.3 percent anticipated in the earlier survey. In the first quarter of 1985, such spending advanced only 1.1 percent on an annual basis. Further grim news from the business sector came when the National Association of Purchasing Managers composite index of business health in June was at its lowest level since December, 1982.

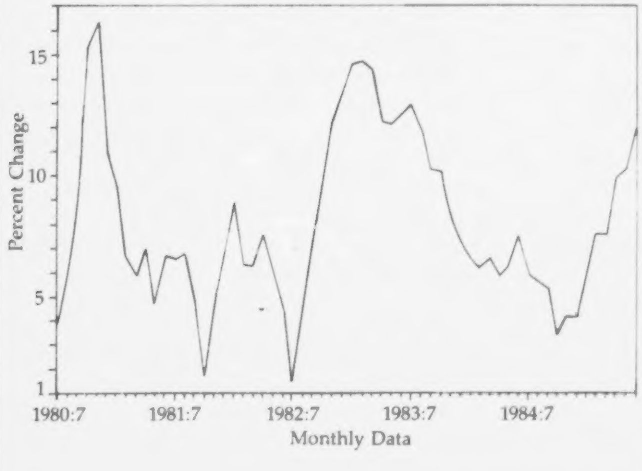
Like housing, the retail market is also sending off mixed signals about where it's been and where it's going. April data was revised upward to a 2.4 percent gain in sales, an extraordinary performance for a single month, but May's preliminary number, which is subject to substantial revision, registered a fall of 0.8 percent. June sales of domestic autos dropped to 7.6 million units at a seasonally adjusted annual rate, down from 8.4 million in May and 8.1 million in June a year ago. With both domestic and imported car sales down in June, it's likely that retail sales for the month will show little or no growth as well. The many factors that contribute to consumer sales give little reason to be optimistic about near term trends. Personal income fell in May, and in June, the Labor Department's household survey reported that the number of employed persons declined. Consumer sentiment fell 2.8 percent in May to the lowest level since 1983 and the Chamber's own Early Outlook Sales Survey, a nationwide compilation of retailers' attitudes, shows steady but modest deterioration since April. Not one respondent expected higher sales in the June survey. In recent months, much has been made of the growing consumer debt burden and the adverse impact this might have on future sales trends. So far this year, outstanding consumer installment debt has risen 23 percent at an annual rate compared to 20 percent last year. As a result, the ratio of outstanding installment debt to disposable income reached 17.9 percent in April, exceeding its previous peak of 17.8 percent reached in late 1979.

All in all, the list of mixed and pessimistic news is long and comprehensive and suggests that we have some real problems at the moment. Or does it? What we should bear in mind in watching these numbers is that they all largely reflect something that happened in the recent past, whereas our concern and interest lie in the future. In this respect, the attitudes that characterize the current situation are not much different from those that prevailed at the end of 1982 when the economy was poised to take off on the strongest recovery of the postwar era. What we have experienced for the past twelve months is a lengthy period of limited growth that fell well short of the economic advance that characterized the preceding year and a half. Whether the economy has been level or declining, the economic situation, as evidenced by the monthly data releases, always appears at it bleakest at the end of such a period.

In assessing the prospects for a recession or an even longer period of stagnation, it is important to remember that recessions do not occur by chance or happenstance, but are the logical outcome of a period of severe economic adversity generally characterized by soaring inflation, rapidly rising interest rates, capacity constraints and a monetary policy deliberately designed to take the wind out of the economy. At the moment, none of these factors are present, although brief elements of some were prevalent in late 1984. Indeed, all of these factors are moving in a strong positive direction and should contribute to a reversal of the current period of drift during the second half of this year.

Inflation, of course, has been very well behaved through much of this recovery and shows no sign of moving up to the levels that would alarm policy makers and induce them to restrain the economy by putting the brakes on monetary growth. Interest rates have been falling since mid-1984 and are now as low as they've been since the late 1970s. And finally, after a prolonged period of restraint that probably contributed to the current lackluster economy, the money supply has been booming along at rates sure to stimulate economic growth (and maybe some inflation!) for the remainder of this year and part of next (see Chart 1).

CHART 1
Growth in the Money Supply (M-1)
(6-month growth rate, SAAR)



It is worth considering each of these factors in some detail because, as will be clear from the discussion, their behavior during 1984 may have had an important influence on the slow growth that we have experienced in the year to date. Consider what has happened with Federal Reserve policies and the behavior of the money supply since last year. In the first half of 1984, real GNP growth soared at exceptionally high rates of growth, causing the Federal Reserve and others to worry about an "overheated" economy (remember that one?). Inasmuch as the Fed's objective had become the "stabilization" of economic growth within a range that they believed was consistent with low inflation, it was only natural for them to adopt a policy of restraint in response to the economy's rapid growth in early 1984.

As the record shows, they did this with a vengeance. From June to December of 1984, there was essentially no growth in the money supply. Inasmuch as near-term economic activity is sensitive to the rate of change of the money supply, this policy of restraint, in effect for nearly half a year, contributed to a slowdown from which we are still suffering. Fortunately, this policy was changed in late 1984, but the damage was already done. Perhaps in response to the slowing, which became evident in late 1984, and out of concern that it may have been overdone, Federal Reserve policy rapidly reversed course and, in the all or nothing posture that we have come to expect from our central bank, the money supply has been growing by leaps and bounds (see Chart 1). From December 1984 to mid-June of this year, the money supply grew by 12 percent, an excessive rate by any standard. It is for this reason that we expect economic growth to advance at a reasonably rapid rate during the remainder of this year.

What we have here is a slightly less damaging, but no less disconcerting, version of the policy implementation process that has become typical of the Federal Reserve since the late 1960s. Having abandoned any attempt to engage in meaningful and consistent monetary targeting, the Fed has instead opted to act in a highly discretionary manner by trying to manage the course of the U.S. economy according to its own judgment of where the economy should be, where it is now, and where it might be in the next quarter or two. By leaning with or against the economy, the Fed exacerbates the economic ups and downs and, ultimately, ends up largely reacting to its own past policies as the economy teeters to and fro in response to the stop/go policies of the central bank.

In addition to the induced fluctuations in the economy, these erratic policies also contributed to wide swings in interest rates (see Chart 2). From a low point reached in early 1984, the entire spectrum of interest rates moved up sharply as the economy surged in response to the monetary stimulus and renewed fears of inflation. By July, shortly after the monetary brakes were applied, interest rates hit their peak and began to fall, with some rates reaching a six-year low by mid-1985. At the same time, the economy moved onto the plateau where it would remain for the next 12 months until the cycle begins anew in response to another dramatic reversal in monetary policy.

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS									YEARS		
	Actual		Forecast							Actual	Forecast	
	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	4.2	0.3	3.8	5.0	4.7	4.3	3.5	3.5	2.8	6.8	3.1	4.1
Consumption	3.6	5.2	3.9	3.8	3.8	3.9	3.1	2.3	1.9	5.3	4.0	3.4
Residential Investment	-5.9	5.5	28.1	18.4	16.4	7.1	3.2	-1.2	-0.1	12.2	7.8	8.9
Business Fixed Investment	8.5	-1.5	9.6	11.6	11.7	10.5	8.0	11.2	7.3	19.8	8.0	10.2
Equipment	5.4	-5.6	9.4	13.7	13.2	12.2	9.0	13.5	7.9	21.5	7.2	11.7
Structures	17.1	9.8	10.0	6.6	8.1	6.0	5.3	5.4	5.7	15.6	10.3	6.5
Exports	-0.8	-8.9	5.4	6.5	5.5	6.3	6.2	6.1	6.0	4.7	0.5	6.0
Imports	-28.3	32.2	14.1	13.8	12.7	10.0	7.2	5.3	3.2	27.0	12.2	9.6
Change in Business Inventories (72$)	16.8	19.1	17.7	19.9	20.3	20.1	20.1	19.7	20.0	24.8	19.3	20.0
New Car Sales (mil. units)	10.3	10.9	10.6	10.9	11.2	11.5	11.7	11.7	11.9	10.4	10.9	11.7
Housing Starts (mil. units)	1.6	1.8	1.8	1.9	2.0	2.0	2.0	1.9	1.9	1.8	1.9	1.9
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	7.2	7.3	7.3	7.2	7.0	6.8	6.7	6.6	6.6	7.5	7.2	6.7
Compensation	3.5	5.4	4.1	4.2	4.3	4.8	4.4	4.4	4.4	4.2	4.4	4.4
Productivity	2.3	-2.6	2.6	2.3	2.9	2.2	2.1	2.0	2.0	2.7	0.9	2.4
Unit Labor Costs	1.3	8.3	1.4	1.9	1.5	2.6	2.3	2.4	2.5	1.4	3.5	2.0
Consumer Prices	3.5	3.3	3.9	3.5	3.8	3.9	3.9	3.9	4.0	4.3	3.6	3.8
GNP Deflator	2.8	5.4	3.4	3.1	3.2	3.1	3.2	3.1	3.2	3.8	3.8	3.2
Prime Interest Rate (%)	11.8	10.5	10.1	9.4	8.9	8.7	8.6	8.6	8.5	12.0	9.7	8.6
Profits from Current Production ($B)*	203.9	207.0	214.7	222.2	227.1	229.9	230.9	231.1	230.6	195.9	217.7	230.6
GOVERNMENT FISCAL POLICY ($B)**												
Unified Receipts										666	742	796
Unified Outlays										842	954	983
Unified Deficit										-176	-212	-187

*After-tax corporate profits with inventory valuation and capital consumption adjustments.

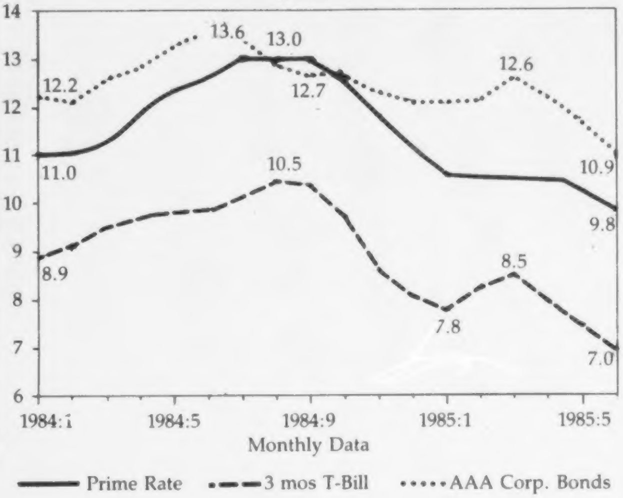
**Unified Budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University Macroeconometric Model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's third revision to the National Income and Product Accounts for the first quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to enact a deficit reduction package which results in a static reduction in federal government outlays of $50 billion in 1986. By then, unified budget outlays are 17 percent higher than they were in 1984. The nation's money supply, as measured by M(1), rises by 7.1 percent in 1985 and 5.8 percent in 1986. The federal minimum wage remains at $3.35 an hour throughout the forecast interval. The price of imported crude oil averages $27.8 in 1986 compared to $28.9 in 1984. The trade-weighted exchange value of the dollar falls by 2.2 percent by the fourth quarter of this year compared to the last quarter of 1984. During 1986, it falls an additional 6.6 percent.

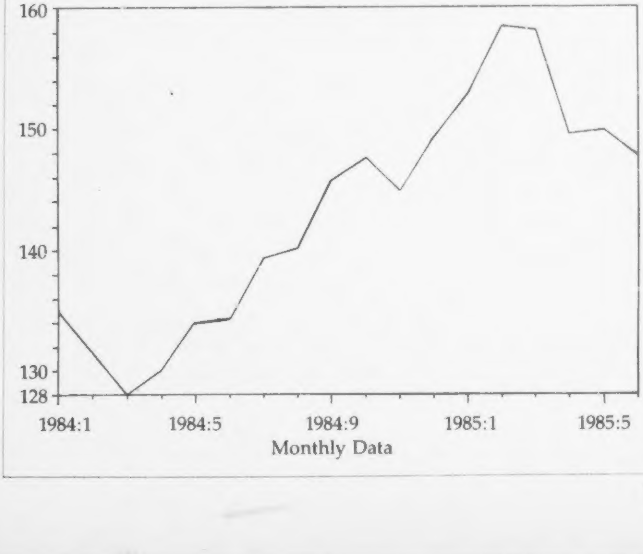
CHART 2
Interest Rates
(Percent)



Although the economy still appears to be stuck on this plateau, we are confident that the next six months will see fairly rapid growth in real GNP. Mixed in with all the bad news are some positive signs for the future. As a result of the interest rate decline, consumer buying intentions remain high and are within five percent of their peak values. Sixty-one percent of the respondents to the University of Michigan survey of buying intentions think that now is a good time to buy a house, and 65 percent think it is a good time to buy a car.

Despite the mixed picture in retail sales, consumer spending registered strong gains in both April and May as reported in the Department of Commerce's personal income series. This, in turn, has led to increased activity at the factory level. In May, household durable goods shipments rose by 6.8 percent. New orders for durable goods increased 4.1 percent, led by a 50.2 percent increase in defense goods and an 8.1 percent increase in household durable goods. The leading indicators also rose in May. Inflation remains low, and the recent declines in oil prices could ensure further near-term relief in energy prices. Finally, of importance to our beleaguered manufacturing sector, the value of dollar continues its steady fall on international exchange markets (see Chart 3). Since early March, the dollar has dropped 24 percent against the pound, 16 percent against the French franc and 15 percent against the German mark.

CHART 3
U.S. Dollar
(Trade weighted exchange value)



As the year progresses, we expect further positive indications of growth to emerge, leading to real GNP growth in excess of 4.5 percent for the remainder of this year. Beyond that, economic activity will depend on the Fed. Sooner or later, the Fed will have to curb the excessive monetary growth of the past seven months, and this could lead to another setback in 1986 if it elects to do this with the abruptness that characterized 1984 policies. Nonetheless, for the near term, we remain optimistic about the prospects for the economy.

TAX INCENTIVES AND THE RATE OF INVESTMENT

by
Ronald D. Utt

Over the past two years, we have frequently noted on these pages the extent to which business fixed investment has led this recovery by growing at a rate well in excess of previous postwar experience. Over the first ten quarters of this recovery, inflation-adjusted nonresidential fixed investment has increased by 30 percent. This is nearly twice the rate of increase in investment (16.4 percent) which characterized the five preceding postwar recoveries.

This boom in investment has gone far towards rebuilding our nation's capital stock and increasing the share of production devoted to future growth and productivity-enhancing investment such as new machinery, computers, factories and automated assembly lines. By the first quarter of 1985, this rapid growth in capital spending raised the share of inflation-adjusted gross domestic investment in our gross national product (GNP) to 12.8 percent. This share compares with an average of 9.8 percent by this point in the last six recoveries. Indeed, on an annual basis, real gross nonresidential investment averaged 12.5 percent in 1984, the highest share ever achieved in the past 24 years.

Some critics of the tax incentives have discounted the importance of these impressive figures by arguing that measures of performance that rely on *gross* investment figures are misleading and that a better measure of performance is *net* investment, which is equal to gross investment less depreciation. They then note that net investment has not done as well and that most of the investment that has taken place has been to replace the capital stock that has worn out or become obsolete as a consequence of rapid technological advance. According to this line of argument, we have added little to our capital stock during this decade.

While this may have been accurate in the earlier part of this expansion, data available through the first quarter of 1985 indicate that net investment is, in fact, advancing at a rapid rate. According to U. S. Chamber estimates, net investment increased by 139.5 percent between the end of 1982 and the beginning of 1985. This compares to an average gain of 45.8 percent in the five earlier recoveries that lasted this long. By the first quarter of 1985, net investment rose to 3.8 percent of GNP compared to an average of 3.0 percent by this point in the past five recoveries.

Role of Tax Incentives

In large part, these impressive gains in our investment performance are directly related to the Economic Recovery Tax Act of 1981 which substantially increased the incentives for businesses and individuals to increase their rate of investment in new factories, office buildings and capital equipment. The combination of the Accelerated Cost Recovery System (ACRS), with its rapid write offs over a shorter period of time, and the Investment Tax Credit (ITC) greatly reduced the cost of capital to business and encouraged the investment boom. Although the anecdotal evidence from the past few years suggests that the tax law changes were responsible for this rapid rate of investment, the availability of more than three years of experience with the system has enabled scholars to carefully evaluate the results to determine the extent to which these tax changes have contributed to our impressive investment performance.

In a detailed econometric study of investment incentives performed for the National Chamber Foundation, Dr. Michael Boskin of Stanford University estimates that "ACRS and the ITC was responsible for about 25 percent of the net investment in the 1982 - 1984 period." In turn, this increase in investment contributed to a $79 billion gain in the GNP between 1982 and 1985. An earlier study by Leonard Sahling and M.A. Akhtar of the Federal Reserve Bank of New York came to a similar conclusion regarding the Economic Recovery Tax Act of 1981. Whereas Boskin only considered the effects of ACRS and the ITC, Sahling and Akhtar considered all of the tax changes, including the lower rates for individuals, and found that the combined effects of ERTA accounted for 40 percent of the increase in investent in producers' durable equipment during this recovery.

All in all, there is every reason to believe that ERTA contributed to a much needed boom in capital spending and that the economy is much better off as a consequence. But with Congress and the Administration contemplating major alterations to the tax code which would generally diminish the incentives to invest, the question we must consider is whether we can now claim victory in our goal of improving U.S. investment performance, and accept something less for the future. While the tremendous boom we have experienced suggests to some that our capital investment problem has been resolved and that a pause is something that we could comfortably afford to accept as the necessary price for comprehensive tax reform, a closer inspection of the investment data from the past several years suggests that a number of weak spots remain and that we still have a long way to go before we can consider the problem resolved.

Uneven Performance

The first source of concern becomes readily apparent when the investment trend of the past several years is broken up into its component parts. Then, it becomes apparent that only a few types of producers' durable equipment accounted for most of the investment boom and that business investment in many other types of capital equipment have yet to reach the levels achieved in 1979. Table 1, which ranks twenty types of producers' durable equipment by the amount spent upon each in 1984, shows that for thirteen of the twenty investment types, business spending, after adjustment for inflation, actually declined between 1979 and 1984.

TABLE 1

TYPES OF PRODUCERS' DURABLE EQUIPMENT RANKED BY CONSTANT DOLLAR INVESTMENT IN 1984

Equipment Type	1979 Investment ($ Billions)	1984 Investment ($ Billions)
Office, computing and accounting machinery	$16.2	$39.4
Electrical and communications equipment	19.9	24.2
Autos	10.1	16.9
Trucks, buses, & truck trailers	13.8	12.7
Instruments	9.6	12.7
Furniture and fixtures	4.0	5.3
General industrial equipment	6.1	4.9
Metalworking machinery	6.3	4.8
Special industry machinery	4.4	4.8
Fabricated metal products	3.8	3.7
Other miscellaneous	3.4	3.0
Service industry machinery	3.3	3.0
Aircraft	2.9	2.4
Mining and oilfield machinery	1.7	2.3
Construction machinery	4.2	2.1
Tractors	2.7	2.0
Agricultural machinery	3.9	1.6
Engines and turbines	1.4	1.1
Railroad equipment	2.6	1.0
Ships and boats	1.3	0.6

Source: Department of Commerce and Machinery and Allied Products Institute

Reflecting the rapid gains in technology and the office automation boom, the table demonstrates that fully 85 percent of the increase in producers' durable equipment over the first half of this decade was accounted for by the increase in investment in office, computing and accounting machinery, which more than doubled over the period. In effect, the great bulk of the recent surge in investment has gone into the rapidly growing service sector. Manufacturing, in contrast, still lags behind and has yet to fully participate in the investment boom. (See the companion article, this issue, for a complete discussion of the U.S. manufacturing sector.) Should this weak investment performance persist, our manufacturing sector will continue to be under competitive pressure from abroad, industrial production will remain stagnant, more jobs will be lost, and the trade deficit will widen.

The lackluster investment performance of the manufacturing sector shows up clearly in the relative differences in productivity growth in the manufacturing sectors of the leading industrialized countries. Table 2 compares the U.S. productivity performance with that of nine other countries. Note that while we have certainly improved our performance in recent years, our productivity growth rate still falls short of most of our competitors'. In 1984, Japanese manufacturing productivity growth was nearly triple ours, thus continuing the trend of the last dozen years which has allowed them to successfully penetrate our markets at the expense of our less efficient domestic producers. Unless this vast difference in relative productivity growth is narrowed, foreign producers will continue to make inroads into our economy, and our industrial base will suffer accordingly.

TABLE 2
MANUFACTURING PRODUCTIVITY

	Output per hour (percent change)		
Country	**1973-84**	**1983**	**1984**
United States	2.0%	4.3%	3.5%
Canada	1.7	6.4	4.0
Japan	7.3	5.1	9.5
Denmark	3.6	3.0	4.1
France	4.6	4.3	5.0
Germany	3.3	4.7	4.7
Italy	3.7	2.4	6.3
Norway	2.3	5.9	1.7
Sweden	2.9	8.4	6.8
United Kingdom	2.3	6.7	3.9

Source: U.S. Department of Labor

Potential Impact of Tax Reform

Despite this apparent risk, the Administration's most recent tax reform proposal would further diminish the investment tax incentives and, according to several econometric studies, contribute to a decline in the rate of investment over the foreseeable future. In a study of the new proposal presented in testimony to the Ways and Means Committee, Dr. Joel Prakken of Washington University estimates that the combined effects of the new tax plan would be to raise the rental price of producers' durable equipment by about ten percent. Given this higher cost, Prakken's analysis finds that investment in equipment will fall by more than any other category of investment. Other analysts have conducted similar studies and all conclude that investment in producers' durable equipment will be less under the new tax proposal than what would otherwise occur under current law. Table 3 presents the findings of these studies from three major models of the economy.

TABLE 3
CCRS IMPACT ON REAL INVESTMENT IN PRODUCER'S DURABLE EQUIPMENT
(percent difference)[a]

Model	1986	1987	1988	1989	1990
Data Resources, Inc.	+0.3	−1.5	−1.9	−1.9	−1.4
Washington University	−4.1	−5.1	−5.2	−4.8	−3.8
Chase Econometrics	−4.8	−1.0	−0.6	−1.4	−2.6

[a] Shows the difference in percentage terms, between the anticipated level of investment in PDE under the Administration's tax reform plan, and what would otherwise have been the likely path of PDE investment.

According to these models, the enactment of the Treasury's proposed Capital Cost Recovery System, which is to replace ACRS and the ITC, will lead to a decline in spending on producers' durable equipment (from what would otherwise have been the likely path of PDE investment), ranging anywhere from slightly more than one percent to as high as five percent per year over the remainder of the decade. Although the percentages are small, they amount to billions of dollars of lost spending on new investment. Without this investment, the economy will grow more slowly, productivity growth will diminish and our competitive position in the world economy will be at risk.

U.S. MANUFACTURING IS ALIVE AND WELL

by
Rajni Bonnie Ohri

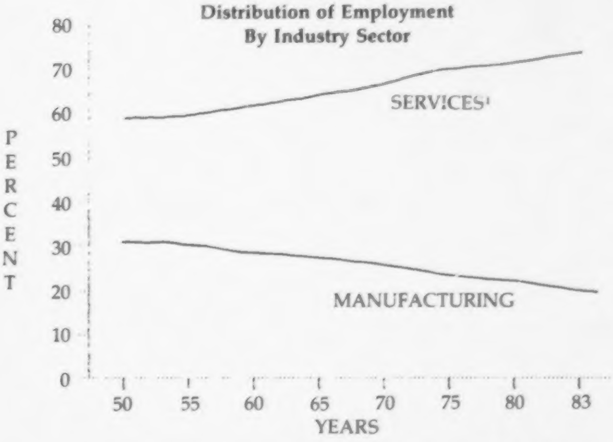
Over the past few years, concern regarding the "deindustrialization " of the American economy has escalated, prompting some to advocate government intervention to stem the decline. Judged by criteria such as overall economic growth, capital formation, productivity, profitability, and international competitiveness, the U.S. appeared to have entered a period of secular decline in the 1970s. This situation was further aggravated during the prolonged period of stagnation beginning in 1979 and the back to back recessions of 1980 and 1981-82. However, a careful analysis of the data shows that the U.S. manufacturing sector is *not* in a state of precipitous decline, as industrial policy advocates maintain.

This article examines the data for manufacturing output and employment to test the assertion that the U.S. economy is "deindustrializing". The results, however, suggest that what is occurring is not an across-the-board decline in manufacturing activity. Rather, we are experiencing a significant shift of resources towards high-productivity industries which are better able to compete both domestically and internationally, at the expense of a few industrial sectors which are hard-pressed by foreign competition.

Employment in Manufacturing

The contribution of manufacturing to the output of the economy has remained relatively stable over the past two decades, even as service-producing industries have become more important. Continuous economic change, however, has redistributed the labor force among major industrial sectors. Although in absolute terms manufacturing employment grew during the past two decades, its relative share of total employment declined (see Chart 1). A popular claim made by industrial policy proponents is that employment in manufacturing has fallen sharply, forcing large numbers of workers into low-paying service sector jobs. However, the data shows that there has been a rise, not a decline, in manufacturing employment over the past several decades – from 16.8 million workers employed in 1960 to 19.4 million in 1970 and 20.3 million in 1980. Further, since the current recovery began in November 1982, 1.4 million new jobs have been created in the manufacturing sector, representing over 16 percent of total job creation in the U.S. economy. And, the Bureau of Labor Statistics estimates that manufacturing employment will continue to increase through 1990.

CHART 1
Distribution of Employment
By Industry Sector



[1]Services include transportation, public utilities, trade, finance, insurance and real estate services, government, and miscellaneous.

Source: Bureau of Labor Statistics

Within the manufacturing sector, however, gains and losses have been distributed unevenly among industries. Some industries, such as basic steel and mill products, have declined in terms of both output and employment over the past several years. But others, such as communications equipment, electronic components, office and computing machines, have grown impressively (see Table 1). This reflects a substantial shift in employment among industries within the manufacturing sector from low productivity industries to the more productive high-tech industries. Moreover, the spread of high-technology manufacturing will continue to give an important boost to a group of services closely linked to manufacturing – consulting, data processing and engineering, among them.

TABLE 1
TEN INDUSTRIES WITH LARGEST EMPLOYMENT GAINS ABOVE PRE-1980 RECESSION PEAK
(seasonally adjusted)

Industry Title	Employment Gain (in thousands)
Communication equipment	119
Electronic components and accessories	[illegible]
Office and computing machines	102
Commercial printing	71
Miscellaneous plastics products	71
Guided missiles, space vehicles	68
Newspapers	27
Motor vehicles and equipment	24
Periodicals	21
Miscellaneous publishing	21
TOTAL	643

Source: Bureau of Labor Statistics

Trade and its Affects on Industry Employment

The widespread publicity afforded the current import pressures faced in the automobile, steel, textile and shoe industries has contributed to the mistaken impression that America is being flooded by a tide of foreign imports. Examination of the data reveals, however, that this apprehension may be exaggerated. A New York Stock Exchange study, *U.S. International Competitiveness: Perception and Reality,* reviewed 40 major manufacturing industries, and found that the volume of imports grew less than five percent per year between 1977 and 1983 in 16 industry groups, and less than ten percent per year in 21 other groups. In another nine industry groups the volume of imports actually declined.

The same study estimated that, in 1982, foreign trade resulted in a net loss of 584,000 U.S. manufacturing jobs, that is, 584,000 more manufacturing jobs were taken away from Americans by foreign imports than were created by U.S. exports. However, this loss represents less than three percent of all manufacturing jobs and was concentrated in four industries: apparel, motor vehicles, shoes and leather, and iron and steel. Further, the losses experienced by these industries were counterbalanced by major job gains in computers, aerospace, construction, mining and oilfield equipment. In fact, aside from these four industries, foreign trade accounted for a net addition of 64,000 manufacturing jobs in 1982.

There is no doubt that the loss of competitiveness during the 1970s was a serious problem for some industries, but the source of the problem was primarily domestic. Without increased trade, the growth in U.S. employment during the 1970s would have been much less robust. Many studies have attempted to estimate the number of jobs lost as a result of increased imports of manufactured products, but the task is not easy. Jobs lost will depend on the labor intensity of the products being displaced and on the indirect effect on employment in industries supplying the directly affected industry. In any case, job displacement should be measured against job creation by expanded exports of manufactured products to our trading partners.

Trends in Manufacturing Output

An analysis of output trends for key sectors of the American economy reveals some interesting results about the underlying strengths of industry. During the 1981-82 recession, total durable goods production declined by 11 percent; smaller declines occurred in the broader aggregates, such as total manufacturing and industrial production (see Table 2). All three aggregate measures, however, remain substantially above the levels of the 1970s.

Looking at the individual industry groups shows a more diverse pattern of movement. For example, primary metals (including steel) took a tumble, declining by 31 percent between 1981 and 1982. In contrast, transportation equipment fell by only nine percent, and instrument producers reported a five percent drop in output. However, of greater interest is the nature of the snapback in 1983. Two industry groups, electrical machinery and transportation equipment, exceeded their 1981 highs. At the other end of the spectrum of performance, the 1983 recovery in primary metals (up 13 percent) did not return that industry to its 1975 level of output. Nevertheless, taking full account of the variations among industries, it seems clear that the decline in heavy manufacturing industries that was so noticeable in 1982 did not represent a new and durable long-term trend. Rather, the decline was primarily the result of a severe, but short-term cyclical contraction.

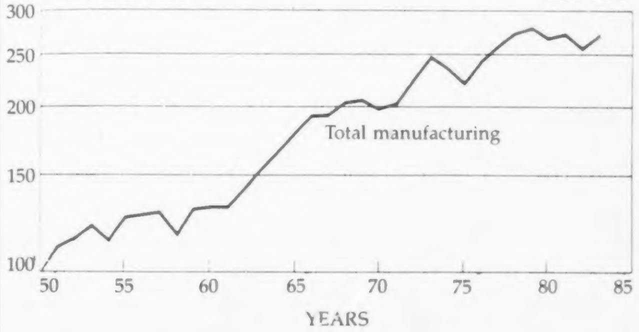
TABLE 2
PRODUCTION INDEX FOR SELECTED DURABLE GOODS MANUFACTURING INDUSTRIES
(1967 = 100)

Industry Group	1970	1975	1980	1981	1082	1983	Dec. 1983	May 1985
Primary Metals	107	96	102	108	75	85	90	97
Fabricated metal products	102	110	134	136	115	120	129	141
Electrical machinery	108	117	173	178	169	186	201	216
Nonelectrical machinery	104	125	163	171	149	151	164	189
Transportation equipment	90	97	117	116	105	118	131	146
Instruments	112	132	171	170	162	159	165	179
Total Durable Goods	102	109	137	141	125	135	145	158
All Manufacturing	106	116	147	150	138	148	157	167
Total Industrial Production	108	118	147	151	139	148	156	165

Source: Federal Reserve Bulletin, various issues.

Manufacturing output made an impressive recovery in 1984, rising by nearly 12 percent, compared with 1983, thanks to large gains in the high-tech and sophisticated equipment industries (see Chart 2). In a recent report on the manufacturing sector, Data Resources, Inc. (DRI) predicted that the growth of the computer, telecommunications, biotechnology and factory automation sectors will more than offset declines in older, basic industries, such as steel products, permitting manufacturing to hold on to the same share of the nation's economy it now has. Manufacturing output has continued to account for about one-quarter of the total output of the economy throughout the postwar period.

CHART 2
Output in Manufacturing[1]



[1] Gross product originating in manufacturing, constant dollars.

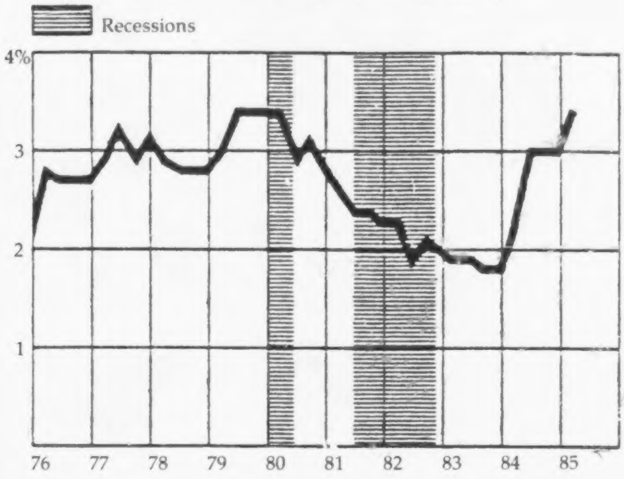
Source: Bureau of Labor Statistics

The point to be emphasized here is that our experience during the past decade has been typical of economic swings associated with the business cycle. For some industries these swings have been severe, but on reflection, when the economy goes through a recession, it is not surprising to see a disproportionate decline in manufacturing industries. The other side of the coin, however, is that during the economic recovery of 1983 and 1984, these same industries recovered from the recession more rapidly than the rest of the economy. Thus, the current data do not support the pessimistic prediction that our manufacturing sector is in a decline.

Growth of Manufacturing Capacity

Since 1976, overall manufacturing capacity has risen by 27 percent. During the first quarter of 1985 the rate of growth in capacity rose by 3.2 percent, the fastest quarterly growth rate since 1976 (see Chart 3). Over that period, as Chart 4 shows, capacity in some industries – chemicals, rubber, plastics – has soared. In some others, to be sure, there was relatively little gain, and in one extreme case – iron and steel – capacity actually declined.

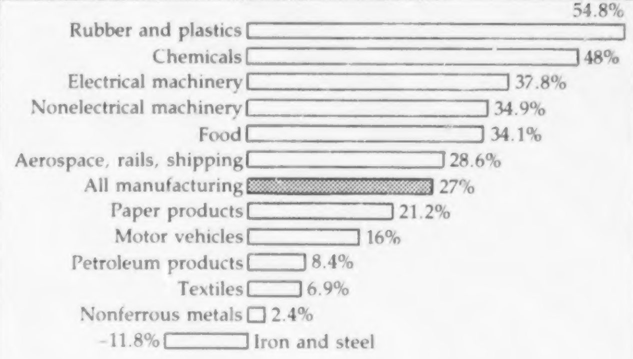
CHART 3
Growth of Manufacturing Capacity
(Annual rate of change, plotted quarterly)



Source: Federal Reserve Board and Department of Commerce.

However, as Chart 3 shows, the surge in the rate of growth of factory capacity largely reflects an exceptional rise in investment since the last recession. Analysts attribute this not only to an unusually low investment rate in that recession, but also to various tax incentives implemented in recent years to spur capital outlays. These include increases in the investment tax credit, an accelerated cost-recovery system that shortens the write-off period for plant and equipment, and a new tax credit for research and development. Looking ahead, a recent survey of more than 500 companies by McGraw-Hill Inc. finds that manufacturers' 1985 outlays aimed specifically at expanding production capacity will lead to a five percent rise in physical capacity this year and next.

CHART 4
Change in Capacity
(since 1976, by industry)



Source: Federal Reserve Board.

In some industries, the rise in productive capacity has also resulted from striking technological advances that have little to do with building new factories or new production lines. In the chemical industry, new catalysts can raise an old plant's output by as much as 400 percent without any new equipment. General Electric now makes 2,000 versions of its basic electric meter at a single small plant. And, in the textile industry, lasers inspect 10,000 yards of cloth an hour – 15 times faster than a human once could.

In addition, foreign competition is forcing some industries to spend more on equipment, which will ultimately reduce costs and increase productivity. The need to modernize in order to remain competitive has become paramount. One of the best examples of the changes in the manufacturing industry is Cleveland-based Eaton Corp. which has streamlined operations, strengthened its balance sheet, tightened quality standards, and shed ailing businesses to lower costs. Also, Deere and Company's tractor works facility includes totally automated machines and conveyors linked to a computer; it can now turn out tractors in more than 5,000 configurations.

U.S. Industry Will Survive

The health of an industry is determined not by its demand for inputs but by its supply of output, i.e., by its contribution of goods and services to society's standard of living. Between 1950 and 1983, manufacturing output increased by 170 percent while manufacturing employment rose by 21 percent. But increases in manufacturing output without equal increases in manufacturing jobs are not a sign of weakness. Instead, they signify higher productivity and as a result, higher living standards. In fact, during the same period, manufacturing productivity increased by 126 percent.

Indeed, the data reveals that in each of the past six recoveries, a higher level of manufacturing output has been attained with fewer workers. For example, twenty months after the recent recovery began, industrial production was 23 percent above the level of output at the trough of the recession, and 7.9 percent above the all-time high for this index. Yet, with all this spurt in production the actual number of persons employed in the manufacturing sector was still 1.7 million workers below the level of 1979, when industrial production was 7.3 percent lower than it is today.

In addition, productivity has advanced in almost all manufacturing industries since the 1960s. In general, relatively brisk productivity advances within manufacturing industries have served to boost business productivity overall. Last year, for example, the hourly output of manufacturing workers rose 3.5 percent, while the hourly output of workers in all businesses, including services, increased by only 2.3 percent.

Conclusion

It appears that much of the concern about the decline of the U.S. manufacturing sector stems from the unfortunate tendency to extrapolate the experiences of a relatively small number of industries which have hit upon hard times. These include the following industry groups: motor vehicles, iron and steel, shoes and leather, apparel, textiles and knitting. Yet, a close examination of the output and employment data of these troubled industries shows that they are not representative of the entire manufacturing sector.

According to the New York Stock Exchange study referred to previously, these six industries combined accounted for only 4.5 percent of total employment and 5.6 percent of total output in 1977. By 1983, their respective shares had fallen to 3.9 percent and four percent. In addition, during the period 1977-83, employment in these six industries declined by 17 percent and the value of their combined output also fell by 14 percent. However, the remaining manufacturing industries, which account for four-fifths of total manufacturing output, (the total less the six troubled industries) performed much better during the same period, employment rose by six percent and output increased by 14 percent. These data make it clear that despite some very troubled industries, on the whole, the manufacturing sector has not performed badly.

In sum, what is occurring within the manufacturing sector is a gradual but significant shift of capital and labor resources toward industries with higher productivity and away from industries employing less skilled labor. During the process of industrial restructuring, traditional industries such as steel, automobiles and textiles have become less important sources of employment, but this does not imply that basic industries will no longer be significant to the economy. Although the output of these industries may grow more slowly, resources will gradually shift toward high-skill, high-technology types of production within each industry. Indeed, the decline of output and employment in these traditional industries has been neither large nor rapid, and the overall growth of the manufacturing sector demonstrates that the industrial base is changing its composition, not declining in importance.

TRENDS IN COMMERCE NOTES ON TABLE II JULY, 1985

by
Martin Lefkowitz

Beginning with this month's issue, the *Trends In Commerce* summary will include three additional indicators designed to measure economic activity in the services sector. Most of the closely followed gauges of the U.S. economy are measures of activity in the goods-producing sector and tend to ignore services – the fastest growing sector. For instance, indicators such as industrial production, housing starts, and retail sales all measure economic activity in the goods sector. The leading economic indicators, a gauge of future trends in the economy, is heavily weighted in the direction of the goods sector. The leading index includes such indicators as the average workweek in manufacturing, new orders for manufactured goods, vendor performance on delivery of goods, orders for new plant and equipment, change in business inventories and building permits. Even in the stock market, the most closely watched indicator is the Dow Jones Industrial Average. The reported data on international trade also show an obsession with the merchandise trade deficit, tending to ignore the fact that the U.S. runs a surplus in trade in services.

It is because of this benign neglect that we are now adding three indicators of services sector activity and will seek to expand this section in the future. The three new series that appear in this month's summary of economic trends are: (1) consumer purchases of services, (2) revenue passenger miles flown by major U.S. airlines, and (3) service sector employment. The definition of services that we will use is the standard national accounting concept of services, that is, all output not accounted for by the four goods-producing sectors of the economy (agriculture, mining, manufacturing, and construction), are allocated to services.

Gross National Product (GNP) – The Department of Commerce's revised estimate of the nation's economic performance as measured by the Gross National Product – the value of the output of goods and services – indicates that the inflation-adjusted growth rate in the second quarter picked up to a seasonally adjusted annual rate of

3.1 percent. The data continues to indicate that personal consumption and business investment are growing rapidly, with residential investment and government purchases showing smaller gains. It appears that businesses were living off their inventories in the second quarter. This should boost economic growth later in the year as depleted inventories are replaced. The first quarter growth rate of 0.3 percent now being reported is about one-seventh the 2.1 percent growth rate estimated in the flash forecast issued in March.

The Services Sector– The service industries continue to be the growth sector of the economy. Comparisons between growth in services and recent growth in goods underscore the dramatic differences in the trends. Employment in service sector establishments rose by 0.5 percent in May and is now 4.5 percent above its year-ago level. This compares with no change in employment in the goods producing sector in May and a 1.7 percent increase in the last year.

Consumers continued to increase spending on services despite a lackluster performance in the goods sector. May data indicate that while retail sales were declining by 0.8 percent for the month, consumer expenditures on services soared by 0.7 percent. In addition, consumer purchases of services were up 8.8 percent from a year ago compared to an increase in retail sales of 5.3 percent from last May. Consumer purchases of services now comprise 50.4 percent of personal consumption expenditures. This compares to 1984 when services accounted for 49.3 percent of personal consumption expenditures. One of the services getting an increasing share of the consumer dollar has been travel. Revenue passenger miles flown, that is the number of passengers multiplied by the miles flown by each passenger, increased 5.3 percent in May from April and was up nearly 15 percent from its level of last May.

Money Supply–The nation's money supply–as measured by M-1, currency in circulation plus demand deposits–increased by 1.2 percent in May, about twice the rate of growth in March and April. The money supply, in the latest three-month period, has been growing at an 8.5 percent seasonally adjusted annual rate, above the Federal Reserve's target range of 4 to 7 percent.

Employment–The civilian unemployment rate remained unchanged at 7.3 percent in June for the fifth month in a row. Civilian employment–as measured by the monthly survey of households–decreased by 590,000 persons (seasonally adjusted). However, the number of jobs in June, before seasonal adjustment, increased by almost one million. The reason for the stagnant rate of unemployment is the continued flow of new entrants and reentrants into the labor force that swells the ranks of the unemployed. On the other hand, the number of nonagricultural payroll jobs–as measured by the monthly survey of business establishments–increased by nearly 900,000 since February, reflecting the continued strength of service sector and construction employment.

Prices–The Consumer Price Index for all urban consumers (CPI-U) increased 0.2 percent in May, following a 0.4 percent increase in April. The index for May showed that prices for food, clothes and transportation declined, while the price of housing rose substantially. The transportation index declined due to smaller increases in gasoline prices. The lifting of the import restrictions on Japanese cars has resulted in lower prices for both new and used cars.

Wholesale prices of finished goods were unchanged in June from May and were up only 1.1 percent from their year ago level. This followed three consecutive monthly increases in wholesale prices. The index for energy prices turned down after substantial increases in April and May, while capital equipment prices were up 0.4 percent after two months of remaining unchanged. From June 1984 to June 1985, the finished goods index increased by only 1.1 percent. This increase is less than one-third the 3.7 percent increase in consumer prices in the last twelve months, reflecting the fact that the Producer Price Index only measures the goods sector of the economy while the the Consumer Price Index measures both goods and services.

Producer prices of crude goods declined in June for the seventh consecutive month. The June decline of 0.6 percent in crude materials prices was the smallest price drop during the year within this volatile sector. Crude materials prices in June were 8.3 percent below their levels of a year ago. Crude food and feedstuff prices have now declined 10.1 percent in the last year.

Housing Starts–Housing starts plunged 13.7 percent in May to 1,663,000 units from a revised 1,927,000 units (seasonally adjusted annual rate) in April. The April starts were the best level for any one month in a year. The drop in starts was viewed as a statistical fluke by many economists in light of the decline in interest rates which has lowered the cost of home ownership and increased the affordability of new homes. In addition, building permits, usually an indicator of future activity in the home building industry, continued to rise in May, and new home sales were up by 9.7 percent, indicating demand is responding to the recent interest rate declines.

Industrial Production–Industrial production fell 0.1 percent in May, following a 0.2 percent decline in April. The two sectors that continued to register strong gains were defense and space products, and construction supplies. Production of consumer goods was unchanged in May, reflecting a small decline in the output of home goods and little change in automotive production. Business equipment production declined in May for the fifth consecutive month, but remained six percent above the level of April 1984.

The capacity utilization rate for manufacturing decreased 0.3 percentage points in May as factories operated at 80.4 percent of capacity. The sector suffering the largest decline was electrical machinery, with the utilization rate declining from 86.5 percent to 85.2 percent of capacity. The largest gain among major manufacturing industries was a 0.4 percentage point increase in the utilization rate for motor vehicles and parts. Manufacturing capacity increased 0.8 percent in the first quarter of 1985 and was 3.1 percent above the first quarter of 1984.

Productivity – Nonfarm business productivity fell at a 2.5 percent annual rate in the first quarter, compared with a preliminary estimate of 1.2 percent. The decline was the most severe since the fourth quarter of 1981, when it dropped 4.4 percent. The productivity decline resulted from an increase of over 800,000 jobs in the first quarter (which amounted to a three percent annual rate of growth in employment), while the economy was growing at a much slower rate. The revision in the productivity number can also be attributed to the downward revision of the GNP data. Output was essentially flat while hours worked by employees increased at an adjusted 3.3 percent rate, the biggest jump since the second quarter of last year. The combined effect of employees' working longer hours and producing less caused unit prices in the nonfarm sector to soar at an adjusted annual rate of 8.1 percent.

Interest Rates – At 9.5 percent, the prime interest rate is 3.5 percentage points below last summer's peak, and out of the double digit range for the first time in nearly seven years. The reduction in the prime rate reflected the lower cost of funds to the banks. In the last three months, the Federal Funds rate has declined 162 basis points with other short-term rates showing similar declines. During that same period, money supply (M1) growth has accelerated to an 11.7 percent annual rate.

Business Failures and Formations – Dun and Bradstreet's Index of Business Failures indicates that business failures declined in mid-June and were at their lowest level since March. The index of business failures, which uses October 1983 as a base of 100, decreased to 103.1 in the week ending June 7, 1985. In addition, business discontinuances and business closings were also trending downward in early June.

Dun and Bradstreet reported that 635,000 new business corporations were formed in 1984, an increase of 5.8 percent from the previous year. Fifteen states had increases of 10 percent or more, and eight of the nine census regions reported more new business corporations formed in 1984 compared to 1983. The only region reporting a decrease in business corporations was the West South Central, while the New England region reported the largest annual gain with an increase of 11.5 percent in 1984, twice the national average. The states reporting the largest increases in new corporations for 1984 were Vermont, Georgia, and South Carolina. The number of new business corporations formed in December 1984 was 53,305 (seasonally adjusted), 3.8 percent more than the same month a year earlier. Ten states registered increases of more than 10 percent from their year-ago levels in December, with Vermont, New Jersey and Arizona reporting the largest increases.

Federal Spending – The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased 12.4 percent in May from its year-ago level. In the first eight months of fiscal 1985, federal expenditures increased by 12.2 percent, three times as fast as prices, indicating a real increase in federal spending of about eight percent from the year-ago level. Federal receipts, during the same period, have risen by 12.5 percent as a result of increases in personal income taxes, corporate income taxes, and social insurance taxes. The data on tax receipts indicates that the deficit is the result of excessive growth in federal outlays rather than the 1981 tax cuts.

Personal Savings – Personal savings increased from 4.5 percent of after-tax income in the first quarter to 5.3 percent of after-tax income in the second quarter of 1985. The reason for the increase in the savings rate in the second quarter was that the tax refunds that were delayed in the first quarter of the year finally reached consumers in the second quarter. The impact of the IRS tax refund delays on savings and income were particularly visible in the monthly data as consumers nearly doubled their savings from an annual rate of $94.6 billion in March, when refund checks were being delayed, to $182.5 billion in May, after refunds were received. The delays in the refunds reduced after-tax income by $6.7 billion in February and March, which, when translated into seasonally adjusted annual rates, amounts to over $40 billion, on average, for each of the two months.

Retail Sales – Retail sales declined 0.8 percent in June, but were still up 6.0 percent in the latest three-month period. June retail sales were 4.4 percent above the level of a year ago, indicating that inflation-adjusted retail sales are up about two percent from year-ago levels. Durable goods sales fell 2.1 percent in June, after declining 1.0 percent in May; nondurable goods sales remained unchanged in June after declining 0.1 percent in May.

Trade Deficit – The trade deficit, on a goods and services basis, increased to $74 billion in the first quarter from $56 billion in the fourth quarter of 1984. The deterioration is largely the result of an $11.6 billion increase in imports, while exports decreased by only $3.4 billion in the first quarter. On a monthly basis, the merchandise trade deficit rose by $800 million in May to $12.7 billion, the largest single-month deficit since July 1984. Petroleum imports in May declined 1.1 percent, but this was offset by increases in imports of organic chemicals, clothing, and aircraft. Imports of automobiles from Canada increased,

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Apr/85	238.4	238.3	236.3	0.1	0.9
Gross National Product ($B)	II/85	3,870.2	3,810.6	3,644.7	1.6	6.2
Gross National Product (72$B)	II/85	1,676.2	1,663.5	1,638.8	0.8	2.3
Money Supply (M1) ($B)	May/85	581.6	574.9	542.5	1.2	7.2
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	May/85	2,492.8	2,474.5	2,340.1	0.7	6.5
Personal Consumption Expenditures (72$B)	Apr/85	1,098.0	1,088.2	1,053.9	0.9	4.2
Disposable Personal Income ($B)	May/85	2,768.8	2,724.2	2,549.2	1.6	8.6
Disposable Personal Income (72$)	Apr/85	1,208.8	1,170.7	1,160.4	3.3	4.2
Personal Savings Rate (%)	Apr/85	5.3	4.5	6.1	0.8[b]	−0.8[b]
Civilian Employment (millions)	Jun/85	106.4	107.0	105.4	−0.6	0.9
Civilian Unemployment Rate (%)	Jun/85	7.3	7.3	7.2	0.0[b]	0.1[b]
Average Hourly Earnings	May/85	$8.55	$8.54	$8.29	0.1	3.2
Consumer Price Index (All Urban, 67 = 100) [a]	May/85	321.3	320.1	309.8	0.2	3.7
Purchasing Power of the Dollar (67 = $1.00) [a]	Apr/85	0.311	0.312	0.323	−0.218	−3.55
Prime Interest Rate (%) July 9, 1985		9.5	10.0	13.0	−0.5[b]	3.5[b]
Retail Sales ($)	Jun/85	113.9	114.8	109.1	−0.8	4.4
SERVICES SECTOR						
Employment in Services (Millions)	May/85	72.4	72.0	69.3	0.5	4.5
Consumer Purchases of Service ($B)	May/85	1,251.5	1,242.4	1,154.8	0.7	8.8
Consumer Purchases of Service (72$B)	Apr/85	504.7	503.9	487.2	0.2	3.6
Revenue Passenger Mileage Flown Major Airlines (Millions) [a]	May/85	26,610	25,269	23,204	5.3	14.7
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	I/85	222.3	228.7	243.3	−2.8	−8.6
After Tax [a]	I/85	137.0	141.0	150.6	−2.8	−9.0
Industrial Production (67 = 100)	May/85	165.3	165.5	162.8	−0.1	1.5
Capacity Utilization Rate (Mfg.) (%)	May/85	80.4	80.7	81.7	−0.3[b]	−1.3[b]
New Housing Starts (thou. units)	May/85	1,663.0	1,927.0	1,787.0	−13.7	−6.9
Net Business Formation (67 = 100) [a]	May/85	112.2	115.4	115.7	−2.8	−3.0
New Business Incorporations (Thousands)	Dec/84	53.5	53.5	51.6	0.0	3.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	I/85	163.2	160.0	158.3	2.0	3.1
Unit Nonlabor Costs (77 = 100)	I/85	157.6	155.0	152.5	1.7	3.3
Producer Price Indices (67 = 100)						
Crude Materials	Jun/85	305.5	310.0	333.2	−0.6	−8.3
Intermediate Goods	Jun/85	320.2	319.9	321.5	0.0	−0.4
Finished Goods	Jun/85	294.0	294.2	290.8	0.0	1.1
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	May/85	611.0	626.1	543.6	−2.4	12.4
Federal Government Debt Outstanding ($B) [a]	Mar/85	1,715.1	1,702.8	1,468.3	0.7	16.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	I/85	360.7	367.2	358.9	−1.8	0.5
Imports of Goods & Services ($B)	I/85	435.2	423.2	410.4	2.8	6.0
Balance on Goods & Services ($B)	I/85	−74.5	−56.0	−51.5	33.0	44.7
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	May/85	167.8	166.6	168.2	0.7	−0.2

NOTES: All data seasonally adjusted unless otherwise noted
[a] Not seasonally adjusted
[b] Percentage point difference

while Japanese auto imports declined for the month. May exports declined in agricultural commodities, autos and power generating equipment. However, exports of aircraft, electric machinery, organic chemicals and coal increased.

What's Ahead – The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.7 percent in May, with eight of the ten available indicators up. What was particularly encouraging about the May report was the fact that, after weak showings for the last few months this was a broad move to the positive side of the ledger.

COUNTIES THAT DEPEND ON FARMING

Of the nation's 2,500 nonmetropolitan counties, nearly 700 are considered farming-dependent, according to a study by the Department of Agriculture's Economic Research Service. A farming-dependent county is one in which at least 20 percent of its labor and proprietary income during the period 1975-79 was derived from farming. These counties averaged only 11,932 residents in 1980, compared with an average population of 25,613 for all nonmetropolitan counties. Forty-six percent do not have an incorporated town of at least 2,500 people and nearly 70 percent are not adjacent to a metro area. These conditions, the report concluded, make it difficult for them to become less dependent on farming. Nine of the 20 counties that depend the most on farming are located in Kansas and Nebraska. Here is a breakdown:

County	Percent of Income from Farming
Issaquena, Miss.	74.2
Slope, N.D.	71.1
Cimarron,Okla.	70.6
Arthur, Neb.	68.1
Banner, Neb.	68.0
Wichita, Kan.	64.2
Armstrong, Tex.	64.1
Wheeler, Neb.	64.1
Liberty, Mont.	63.9
Haskell, Kan.	63.7
Sheridan, Kan.	63.6
Crowley, Colo.	63.4
Greeley, Kan.	62.4
Baker, Ga.	61.6
Glassock, Tex.	61.4
McPherson, Neb.	61.1
Hodgeman, Kan.	60.5
Petroleum, Mont.	60.5
Murray, Minn.	60.4
Sully, S.D.	59.9

THE SOUTH AND WEST HAVE FASTEST GROWING METROPOLITAN AREAS

A recent report issued by the Census Bureau states that most of the fastest-growing metropolitan areas are located in the states of Texas and Florida.

The following metropolitan areas have experienced the most rapid growth in population since 1980:

	Percent Change (1980-1984)
Midland, Texas	38%
Anchorage, Alaska	30
Naples, Florida	29
Ocala Florida	27
Fort Pierce, Florida	26
Bryan-College Station, Texas	25
Odessa, Texas	25
Fort Myers-Cape Coral, Florida	23
Melbourne-Titusville-Palm Bay, Florida	21
Austin, Texas	20
West Palm Beach-Boca Raton-Delray Beach, FL	20

TAX BACKGROUNDERS AVAILABLE

The following are a series of recent studies dealing with current taxation issues prepared by the Chamber's Tax Policy Section. Individual copies of these studies may be obtained upon request by writing to Tax Policy Section, U.S. Chamber of Commerce, 1615 H Street, N.W., Washington, D.C. 20062 or by calling (202) 463-5620.

No. 1 "Reagan Soaks the Rich," September, 1984

No. 2 "Investment and Capital Cost Recovery Allowances," July 8, 1985

No. 3 "The Truth About Corporate Taxes," July 8, 1985

No. 4 "Incentive Effects of 1981 Tax Rate Reductions," (available in late July)

No. 5 "Incentive Effects of 1964 and 1922 Tax Rate Reductions," (available in late July)

No. 6 "How to do a Dynamic Revenue Estimate," (available in late July)

No. 7 "Positive Effects of Reduced Capital Gains Tax Rates," (available in late July)

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States
September 1985

REASSESSMENT OF THE NEAR TERM OUTLOOK

by

Richard W. Rahn and Ronald D. Utt

As the economy progresses through the third quarter, it is becoming increasingly unlikely that the Chamber's earlier projection of 4 percent to 5 percent growth for the second half of the year will occur. Instead, economic growth on the order of 3 percent for the next few quarters seems likely to be the best we can expect. This downgrading stems largely from the economy's performance during July and August and suggests that the slowdown that began in mid-1984 is still very much in evidence. An overview of several key sectors of the economy, discussed in detail below, illustrates this point, as well as some of the frustrations that forecasters confront in their efforts to make some sense out of the current economic situation. Nonetheless, there are a growing number of positive signals which suggest that the economy will end the year on a significantly stronger note.

The Housing Sector

The housing sector, a major component of the gross national product and an important bellwether of economic trends, has yet to emerge from its doldrums despite the substantial improvements in those factors that influence the course of the housing market. As was noted in last month's issue of the *Outlook*, housing starts had been drifting down from the near-term peak of 1.9 million units (seasonally adjusted annual rate), reached in April to nearly 1.7 million units in July. So far this year, housing starts are running 6 percent below the comparable period in 1984. What is ironic about this performance is that it has occurred in the face of a substantially improved housing finance market.

Fixed-rate, thirty-year conventional mortgages are now available at 12.2 percent compared to 14.5 percent a year ago. Moreover, adjustable rate mortgages, which account for as much as 60 percent of new mortgage originations, now carry rates as low as 8.5 percent, offering affordability opportunities not seen since brief periods in the mid-1970s. Coincident with the decline in mortgage interest rates has been an ample flow of mortgage credit from a variety of financial institutions and markets. This has permitted continued availability of low-downpayment mortgages. Finally, the excessive home price inflation of the past, which propelled prices up at rates exceeding growth in incomes, has ended. Offsetting these favorable finance trends is a burgeoning inventory of unsold homes and vacant apartments. Since the last quarter of 1984, the rental vacancy rate has remained above 6 percent, the first time it has pierced this level since the late 1970s. At the same time, the homeowner vacancy rate during the second quarter, at 1.9 percent, was the highest rate in any second quarter since 1956.

Although the housing production sector struggles to maintain last year's production rate, sales of new and existing homes, an important indicator of future production, have held up reasonably well. Since the beginning of this year, sales of newly built homes have drifted between the 630,000 to 690,000 annual unit sales range, but jumped to 704,000 units in July, the highest level since late 1983. On a year-over-year basis, sales are 15 percent ahead of last year's level. Sales of existing homes are doing even better. In July, sales of existing homes reached their highest level since October, 1980. If these trends continue, and the recent declines in mortgage interest rates suggest they should, the production rates should soon turn up from their current levels once the excess inventory is worked off.

Other Sales, Personal Income

Trends in the domestic automobile market show some-

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what more weakness than the housing market, although recently introduced sales incentives may soon change this. Domestic auto sales averaged 8.4 million units (seasonally adjusted annual rate) in the first half of the year but dropped to 7.4 million units in July and 6.8 million in early August. To some extent, the just settled auto haulers strike contributed to the decline. Sales did bounce back to an annual rate of 7.6 million units for the mid-August period, but this was below the level of performance for the first half of the year and almost 5 percent below the same period a year ago. The modest increase that did occur in mid-August may reflect the end of the strike and the concessionary finance terms and/or price discounts that have just been implemented by auto manufacturers.

Unlike the housing market, which is free from any international competition, the domestic auto industry is becoming increasingly hard pressed by foreign suppliers, particularly by the Japanese whose production efficiencies and favorable exchange rate make them formidable competitors. Following the dismantling of the auto import quotas in March, Japanese cars have made substantial inroads into the domestic market. In 1984, when the quotas were in effect, Japanese cars held 18.3 percent of the market. In July, 1985, the share reached 23 percent and is expected to rise even further now that the strike is over and inventories are in the process of being replenished.

Total retail sales have followed essentially the same trend as the auto and housing markets since the first half of this year. After reaching a peak in April, monthly retail sales have drifted down in each of the succeeding months. Revised June sales were below those of May, and July was little changed from June. Although July sales, before adjustment for inflation, were up more than 5 percent from last year's level, the year-over-year gains have been narrowing since early spring.

If personal income is any guide to future sales trends, the near-term performance of the U.S. economy may see more of the same. Inflation-adjusted personal disposable income fell by 2.5 percent in June and, based on preliminary estimates of nominal income growth, is likely to have fallen again in July. What strength there was in June was due largely to retroactive Social Security payments that offset the stagnation in wages and salaries. Personal consumption expenditures did not do as poorly as this because consumers were able to maintain spending by decreasing savings. The personal savings rate has been below 5 percent for most of this year and is now the lowest it has been in two years. Preliminary estimates for June and July place it at 3.4 percent of disposable income. Although the monthly personal income statistics are subject to numerous estimation errors, including the complete neglect of the increasingly popular 401(k) plans, recent increases in consumer installment debt confirm this trend. Obviously, if personal income continues its recent pattern of slow growth, consumer spending, which has been one of the stronger components of the GNP so far this year, may soon experience some slippage.

Reflecting the slow growth in the economy, corporate profits of nonfinancial businesses, adjusted for changes in inventory valuation and capital consumption allowances, have been largely unchanged since the peak reached in the first quarter of 1984. However, profits reported for tax purposes have declined somewhat over the same period. The same is true for after-tax corporate profits which have now fallen for five consecutive quarters.

Despite weakening profits, business fixed investment continues to be one of the strongest sources of growth in the economy. After declining by nearly 2 percent in the first quarter, the first decline since mid-1982, investment resumed growing at double-digit rates during the second quarter. The 11.8 percent increase, made this sector the outstanding performer in an otherwise lackluster quarter. With interest rates down, corporate cash flow up and American businesses still facing competitive pressures that necessitate high levels of efficiency, investment should continue at these rates for at least the next four quarters, provided that the economy continues to advance at or above its present growth trends.

Nonetheless, manufacturers' attitudes about the current state of the economy remain depressed. In August, the Purchasing Managers' Composite Index stood at 46.7 percent, the seventh consecutive month that the index has been under 50 percent. Reflecting their gloomy assessment of the situation, purchasing managers polled by the National Association of Purchasing Management in July reported that production in that month had fallen to the lowest level since December, 1982. This assessment is at sharp variance with the government's index of industrial production.

Foreign Trade: A Source of Concern

Beginning in 1983, the U.S. balance of trade turned negative and has worsened substantially with each successive quarter. As the rapid growth in imports overtook exports and the difference continued to widen, the unfavorable trade balance began to exert a significant negative impact on the GNP accounts. From a current dollar deficit of $8.3 billion in 1983, our net export position in goods and services, as measured in the national income accounts (NIA), widened to $93.4 billion during

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the second quarter of 1985. Had our balance of trade not deteriorated further during the second quarter, growth in GNP would have been more than 50 percent higher (3.1 percent versus 2.0 percent) than the rate of growth actually recorded.

The deterioration that has occurred in our trade account since 1983 can be divided into two distinct periods according to the trends in exports and imports that have contributed to the widening deficit. From 1983 to mid-1984, both exports and imports increased, but imports increased at a faster rate, causing the trade balance to deteriorate. From 1983 to 1984, U.S. merchandise exports grew by 8.7 percent while imports grew by 26.2 percent. Since late 1984, however, U.S. exports have shown little or no growth. During the first half of 1985, exports, on a current dollar basis, increased by only 1.9 percent from the same period a year ago. After adjustment for inflation, they have actually fallen. Imports, on the other hand, increased by 7.6 percent over the same period. Although overall growth trends have recently moderated, the disparities remain.

Conflicting forces on the trade sector make it difficult to discern the direction of U.S. trade patterns for the next twelve months. On the positive side, the trade-weighted value of the dollar has fallen by 11 percent from its February peak. However, the effect of this change will not be reflected in the trade data for some time. Moreover, the dollar still remains well above its 1980 level. Also on the positive side is the slower growth in the U.S. economy which will lead to slower growth in purchases from abroad. This has already been reflected in the second quarter. On an NIA basis, there was no change in the real value of imports between the first and second quarter. What deterioration in our trade account did occur was largely due to a fall in exports over the first half of the year. On the negative side, the decline in exports may continue, despite the more favorable dollar, because the economies of our major trading partners are slowing down as well, in some cases at a rate of decline exceeding our own. In the most recently reported three month period, when U.S. growth was only 2 percent, economic growth in Germany, France, Sweden and Switzerland was negative while Japan posted a negligible gain of 0.4 percent. The developing countries, which represent a major market for U.S. goods and services, are still struggling with their debt and are unlikely to reduce import restrictions any time soon.

Emerging Signs of Renewed Strength

Although there is much to be concerned about, some sources of strength are still apparent. Despite the conventional wisdom that we are in the process of *de-industrializing* and that imports are shrinking our manufacturing sector, the index of industrial production continues to advance each month, albeit at slower rates that those experienced during the past two years. In July, it rose two-tenths of a percent for the seventh consecutive monthly increase. Each of these increases have been modest, however, leading to a year-over-year gain of only 1.4 percent. Nevertheless, virtually all major components of the index have participated in this increase, but defense and space equipment have clearly performed far better than any other industry this year. Production of both consumer goods and business equipment have advanced, while parts and materials have fallen somewhat.

So far, most of this article has focused on present trends and their implications for the current state of the economy. Although the sluggish performance in major business segments has spilled over into some measures of consumer and business sentiment, the picture remains basically one of optimism. Last month's *Outlook* noted that the May index of consumer sentiment had fallen to its lowest level since 1983. But in the months since, it regained some of the lost ground. The June index jumped to 96.5 from 91.8 in May and then fell somewhat to 94.0 in July. Similarly, the Department of Commerce's index of leading indicators continues to rise, presaging future strength. After showing steady declines in the last half of 1984, the index has since returned to the levels that prevailed in early 1984 when the economy was booming. The July increase marked the sixth rise in the last seven months.

Supporting a more optimistic assessment of the near-term outlook is the Chamber's own Early Outlook Sales Survey for August which indicates that more and more retail establishments believe that sales are in the process of turning up. Following three consecutive monthly declines in the percentage of respondents who believe that their sales are much higher or somewhat higher than the previous month, the August response rate jumped to 62 percent, the highest since December, 1984 and substantially above the 45.6 percent recorded in July.

Although our expectations of future growth have been lowered, we continue to maintain the view that the economy will soon break out of its year long period of drift and move up to a higher rate of growth. As has been the case in our previous reviews of the outlook, our optimism for the future stems from the rapid and sustained growth in the money supply, as measured by M1, over the past ten months. Sooner or later, this has to lead to a strong advance in the economy. Since last November, the money supply has risen at an annual rate of almost 12 percent, an exceptionally high rate of increase for such a lengthy period of time.

Historically, there is a close relationship between growth in the money supply and growth in the economy. Although the relationship is by no means exact, generally, an acceleration (deceleration) in the growth of the money supply leads to increased (decreased) growth in

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1987
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at a seasonally adjusted annual rate

	QUARTERS									YEARS			
	Actual		Forecast							Actual	Forecast		
	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	0.3	2.0	3.2	4.0	4.2	3.7	3.1	3.2	2.5	6.8	2.5	3.6	2.5
Consumption	5.2	5.4	2.3	3.1	2.2	1.9	1.3	1.6	1.9	5.3	4.0	2.4	1.4
Residential Investment	5.5	5.4	4.4	6.4	0.1	5.1	-2.8	5.4	-5.8	12.2	1.7	3.0	-2.4
Business Fixed Investment	-1.5	11.8	7.1	7.3	8.7	7.5	8.2	7.0	2.4	19.8	7.6	8.0	3.7
Equipment	-5.6	13.2	8.3	8.0	9.6	7.9	9.1	7.1	1.1	21.5	6.9	8.8	2.9
Structures	9.8	8.1	4.1	5.7	6.7	6.5	5.9	6.8	5.7	15.6	9.5	6.1	5.7
Exports	-8.9	-13.0	4.1	5.2	11.8	14.4	13.9	14.9	11.6	4.7	-3.3	8.8	12.9
Real Net Exports (72$B)	-28.4	-33.3	-33.9	-33.7	-31.4	-29.0	-26.7	-23.9	-21.8	-15.0	-32.8	-28.8	-17.4
Imports	32.2	0.0	6.5	4.6	4.1	5.9	5.9	5.9	5.0	27.0	8.0	4.9	4.6
Government Purchases	0.9	0.0	5.3	6.5	6.2	4.9	4.6	2.9	2.4	3.5	7.1	5.1	2.6
Real Final Sales	-0.3	4.7	2.8	3.8	3.8	3.6	3.0	3.2	2.2	5.0	3.3	3.5	2.4
Industrial Production	0.7	2.7	2.7	5.5	6.4	5.8	4.6	5.2	3.3	10.6	2.9	5.1	3.4
Change in Business Inventories (72$B)	19.1	8.3	10.1	10.5	12.4	13.2	13.7	13.9	15.6	24.8	12.0	13.3	16.8
New Car Sales (total, mill.)	10.9	10.9	10.9	10.9	10.6	10.7	10.9	10.8	10.9	10.4	10.9	10.7	10.5
New Domestic Car Sales (mill.)	8.5	8.2	7.8	7.8	7.7	7.7	7.5	7.2	7.3	8.0	8.1	7.5	6.8
New Housing Starts (total, mill.)	1.8	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.6	1.8	1.7	1.7	1.6
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.3	7.3	7.1	7.0	6.8	6.8	6.7	6.6	7.5	7.3	6.8	6.7
Compensation	5.4	4.1	4.2	4.2	4.8	4.3	4.3	4.4	4.7	4.2	4.3	4.4	4.5
Productivity	-3.0	1.0	0.3	1.1	1.6	1.4	1.0	1.2	0.8	2.7	0.1	1.2	0.9
Unit Labor Costs	8.4	3.1	3.8	3.1	3.2	2.9	3.3	3.1	3.9	1.4	4.1	3.2	3.6
Consumer Price Index	3.3	4.2	2.8	3.0	3.6	3.9	4.3	4.2	4.6	4.3	3.5	3.7	4.5
Implicit GNP Deflator	5.4	2.7	3.2	3.0	3.3	3.6	3.6	3.6	4.3	3.8	2.7	3.3	3.9
Prime Interest Rate (%)	10.5	10.2	9.5	9.4	9.3	9.4	9.5	9.6	9.8	12.0	9.9	9.5	9.9
3-mos. Treasury Bill Rate (%)	8.2	7.5	7.2	7.1	7.1	7.1	7.2	7.4	7.5	9.5	7.5	7.2	7.5
Corporate Bond Rate (%)	12.3	11.6	11.1	10.7	10.4	10.2	10.0	9.8	9.8	12.7	11.4	10.1	9.7
Profits from Current Production ($B)*	207.0	212.7	205.3	219.7	227.4	234.4	235.5	239.6	241.9	195.9	211.2	234.2	311.9
GOVERNMENT FISCAL POLICY ($B)**													
Unified Receipts										666	750	787	844
Unified Outlays										842	954	989	1035
Unified Deficit										-176	-204	-203	-191

*After-tax corporate profits with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University Macroeconometric model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revision to the National Income and Product Accounts for the second quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government outlays of $44 billion in 1986 and $68 billion in 1987. The nation's money supply, as measured by M(1), rises by 8.4 percent in 1985, 7.4 percent in 1986 and 6.1 percent in 1987. The federal minimum wage remains at $3.35 per hour throughout the forecast interval. The price of a barrel of imported crude oil averages $25 and $23 in 1986 compared to $28.9 in 1984. The trade-weighted exchange value of the dollar rises 4.2 percent this year on a year-over-year basis. During 1986, it falls by 10.5 percent, and an additional 6.2 percent in 1987.

real GNP within six to nine months. Beyond this, however, the monetary stimulus usually leads to accelerating inflation and an economic reversal. To some extent, the experience in late 1984 and early 1985 conformed to these trends. From May to November of 1984, the money supply grew hardly at all and this could have contributed to the stagnation experienced in the months that followed. However, with the reversal in policy that began last November, it would be expected that the economy would have reversed course as well. That it did not remains one of the mysteries of this business cycle and one of the chief reasons why our forecast for 1985 went awry.

Conclusion

We do not anticipate that this mystery will remain for much longer, and fully expect the business expansion to move forward at a more rapid pace toward the end of this year and continue through 1986. However, because of the many prevailing weaknesses documented in this article, we expect the recovery to advance at rates somewhat less than we anticipated earlier.

On a final note, we want to reiterate our concern, first expressed in the June, 1985, issue of the *Outlook*, about the quality of the government's economic statistics and the extent to which the reported numbers underestimate or improperly account for numerous measures of economic performance. Earlier this year, a report by the Council of Economic Advisors noted that the Department of Commerce's failure to account for declining computer prices led to a 1.2 percentage point understatement of the rate of growth in real GNP in 1984. More recently, the divergence between employment trends and reported GNP growth in 1985 suggests that this and similar problems may persist. In the first quarter of this year, employment data indicated that aggregate hours worked increased 17 times faster than the increase in the volume of goods and services produced, as reported in the GNP accounts. These and other factors, including the absence of good, detailed data on the rapidly growing service sector, suggest that the economy might be doing better than what the official statistics reveal.

REGIONAL SURVEY

by
Rajni Bonnie Ohri

During the past year, measured gross national product has posted very weak rates of growth relative to the experience of the first year and a half of recovery. Although domestic demand has remained strong, marked increases in imports have offset the strength evident in other sectors of the economy. U.S. demand for foreign goods and services has provided virtually the only engine for growth in the global economy, without which worldwide economic activity would have remained in the doldrums. The outlook for the next two years, as the previous article explained, is for continued, albeit, slower growth in the United States. Just as measured GNP masks the strength in domestic demand, measures of overall economic performance tend to obscure differences in economic activity among the nation's industries and regions.

This article examines regional economic performance during the past year, focusing on factors which account for the disparity in economic conditions encountered around the nation. The analysis shows that those areas that have benefited the most from the strength of the expansion share similar industrial characteristics, such as a diversified industrial base and a favorable business climate. Areas which have a tendency to lag behind are relatively more dependent on industries and sectors which have not performed as well as the economy as a whole, including heavy manufacturing and farming. Industrial concentration, as in the case of the East North Central region, may contribute to powerful, even spectacular, growth for years. But, as the experience of Texas, Louisiana, and Alaska shows in the case of energy, this concentration renders the regions extremely vulnerable to changes in economic conditions. On the other hand, regions such as the Pacific and New England, which enjoy a greater industrial diversity within their borders, are more likely to be able to adapt to changing economic conditions.

Most states now realize that they can no longer rely solely on their tradition of industrial prowess or their existing manufacturing base, and are developing new information-age strategies to remain competitive in a vastly different economic environment. Around the country, high technology firms are sprouting up beside farms, factories, and tourist centers. California's Silicon Valley still leads in high-tech activity, but Florida, Massachusetts, Texas, New Hampshire, and North Carolina are close on its heels.

Recognizing that the U.S. economy is now intimately integrated with the world economy, and that fundamental changes are taking place there as well, a number of states have sent trade missions overseas in an effort to lure foreign businesses to their borders. Many states—Georgia, Florida, Oregon, Tennessee and New Mexico, among them—have experienced phenomenal success by systematically removing barriers to foreign relocation. In addition, more states are becoming aware that exporting is an integral part of their economic development. Oklahoma has led the way in integrating its export programs, and Texas and Nevada have also created new export finance facilities. Thirty states now have offices in 11 different countries.

OVERVIEW

America's demographic profile reflects a continuing urge to follow the sun. Between 1980 and 1983, the fastest growing regions were still the South and West. By the year 2000, California will still be the most populous state, but Texas and Florida will likely nudge New York out of its second place ranking and push it to fourth, as population growth in those states places them in second and third place, respectively. Although migration accounts for some of the growth in the South and West, states in the Northeast and Midwest will not be turning out the lights. The latest census data show Ohio, Indiana, Michigan, and Iowa growing again after losing population in 1981-82. All New England states recorded a gain in 1984, with Massachusetts showing the fastest growth rate. In fact, only three states – West Virginia, Oklahoma and Wyoming – lost population in 1984, but none dramatically.

TABLE 1
PER CAPITA INCOME BY REGION
($ Thousands)

	1984	1983	Percent Change
U.S. Total	12.7	11.8	9.7%
New England	14.2	13.0	10.2
Middle Atlantic	13.8	12.7	8.8
South Atlantic	12.0	11.1	10.5
East North Central	12.6	11.5	10.2
West North Central	12.5	11.3	11.3
East South Central	10.0	9.1	9.8
West South Central	11.9	11.1	9.0
Mountain	11.7	10.9	9.3
Pacific	13.9	12.9	9.3

Source: Survey of Current Business, April 1985

Per capita personal income for the nation as a whole posted a healthy 9.7 percent increase in 1984 compared to 1983 (see Table 1). The South Atlantic, New England, and North Central states enjoyed above average income growth, while the slowest growing regions were the Middle Atlantic and West South Central. State per capita income in 1984 ranged from $17,155 in Alaska to $8,857 in Mississippi, compared to a national average of $12,707.

TABLE 2
RETAIL SALES BY GEOGRAPHIC AREA
(Percent Change, April '84–April '85)

U.S. Total	7.4%
New England	4.0
Middle Atlantic	5.3
South Atlantic	8.5
East North Central	10.4
West North Central	7.6
East South Central	3.9
West South Central	4.0
Mountain	8.1
Pacific	9.6

Source: U.S. Department of Commerce

In the year to April 1985, national retail sales increased 7.4 percent. Regional performance ranged from a 10.4 percent increase in the East North Central region to only 3.9 percent in the East South Central (see Table 2). The data agrees with results from the latest Chamber retail sales survey, a nationwide compilation of retailers' attitudes, which shows a similar regional breakdown of total retail sales.

TABLE 3
UNEMPLOYMENT RATE
(Percent of Labor Force)

	May 1985	May 1984
U.S. Average	7.3%	7.8%
New England	4.6	5.0
Middle Atlantic	6.2	6.7
South Atlantic	6.4	7.3
East North Central	8.1	9.0
West North Central	5.4	5.5
East South Central	8.3	9.6
West South Central	7.9	7.8
Mountain	6.8	6.5
Pacific	7.7	8.3

Source: Bureau of Labor Statistics

In May of this year, the nation's civilian unemployment rate stood at 7.3 percent, down from 7.8 percent in May 1984. As Table 3 shows, most of the regions shared in this improved employment situation. New England's jobless rate is 4.6 percent and falling fast. However, in the East South Central states, the unemployment rate is still over eight percent, and in the West South Central and Mountain regions, more people were out of work this year than last. The states with the highest unemployment rates are West Virginia, Illinois, Pennsylvania, Michigan, Iowa, and Ohio. Arizona, Georgia, and New Hampshire, on the other hand, have enjoyed the most rapid growth in jobs this year. By industry, nearly every state reported job gains in trade, services, finance, insurance and real estate, and over one-third had increases in manufacturing employment.

New England

Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont

Once dominated by textile mills and shoe factories, New England is now dotted with high-tech firms, service industries and some of the nation's finest recreational facilities. A recent study by the Naisbitt Group cited Connecticut, Massachusetts, and New Hampshire among the top ten states with the best business environment, particularly for small business.

At 4.6 percent, New England's unemployment rate is the lowest in the nation. Reflecting the strength in regional employment, 1984 per capita personal income was 0.5 percentage points above the national average. Correspondingly, manufacturing wage levels have increased over 5 percent in most of the states in the region. Indeed, regional economic growth appears to be outpacing rapid labor force expansion. Industry analysts estimate that 180,000 new jobs will be created in New England this year, up from 156,000 in 1984. The rise in total employment has improved consumers' real disposable income, creating greater demand for services, durable goods and houses.

At the heart of New England's growth is its strong high-technology manufacturing sector. In 1984, private companies invested nearly $200 million and the government spent an additional $61 million creating new opportunities in high-tech industries in Lowell, Massachusetts. The city now boasts the lowest unemployment rate in the state and the fifth lowest in the country. Massachusetts' Route 128 area, the East Coast version of California's Silicon Valley, is booming with electronics firms and will see continued growth this year. Connecticut's economy also continues to charge ahead, principally on the strength of increased defense contracts and strong orders for transportation equipment. Maine's service-oriented economy is solid and growing. Moreover, the Navy's recent decision to award a $321 million contract to build a new class of destroyers at the Bath Iron Works should boost manufacturing employment. New Hampshire's unemployment rate is 4.5 percent, and may drop even further when Data General opens its Durham plant and Apollo Computers hires new workers for its Hampton plant. Together, these two firms should create 2,200 new jobs in the state. In an effort to stimulate farming, Vermont state officials will help farmers to develop new markets for their products. The state is also creating a private, profit-making venture capital corporation to give small businesses a leg up. Rhode Island, which has not yet been swept up in the high-tech tide, continues to lag the regional upturn. However, the state is currently undergoing a revitalization of its business climate and should see rapid job growth this year.

The construction boom and the mix of industry within the states helps to explain the robust economic growth of New England. Construction of new homes turned in a tremendous increase this year compared to last year's performance and the construction industry expects another profitable year. With over a quarter of its manufacturing output in electronics, computers, instruments, nonelectrical machinery and machine tools, the region has an impressive base of products. Most of these industries are expected to grow by over five percent this year as compared to 1984. Business services are also growing rapidly, reflecting the strength in manufacturers' demand for research and development and data processing services. The sore spots on the economy are the fabricated metals industry, which will see growth of only 1.5 percent, and the leather products industry which is projected to lose a substantial portion of its market share. The jewelry industry, which accounts for over six percent of all jobs, is also expected to decline as foreign competition continues to take a larger share of the U.S. market.

Middle Atlantic

Delaware, New Jersey, New York, Pennsylvania

The Middle Atlantic region should fare well this year. Manufacturing output for its basic industries is up, personal income is rising, and retail sales are strong. However, population in the region is growing at the slowest rate in the nation. The average unemployment rate was 6.2 percent, with Pennsylvania showing the highest jobless rate at 8.4 percent. Most of the region's lackluster employment performance can be attributed to its dependence on heavy industry. Nevertheless, industry analysts expect that 100,000 new jobs will be created this year in high-tech and service industries of the New York/New Jersey area.

Last year's increase in regional housing construction was the highest in the nation. Housing demand continues to encourage significant increases in construction employment and the construction-related industries such as stone, clay, brick and glass. The electrical equipment and nonelectrical machinery sectors, which make up one-sixth of the manufacturing output in the region, should continue to exhibit strong growth. The instruments industry has made an impressive recovery, with Eastman Kodak responding to foreign competition by streamlining operations and boosting employment in the Rochester, New York area. The decline of the region's apparel and primary metals industries reflects manufacturers' inability to compete with foreign products. However, the strength and the stability of the region's nonmanufacturing sector, in particular finance, insurance and real estate, will continue to invigorate the regional economy.

Diversification of their existing industrial base with an emphasis towards promoting high growth sectors promises to substantially improve the economic performance of the Middle Atlantic states. Pennsylvania has focused on the computer and robotics industries. The state ranks sixth in the country in university-based research which now stands at more than $280 million a year. Internationally renowned Carnegie-Mellon University is pioneering research in robotics, computer sciences, and artificial intelligence within the state. Recently, Rand McNally, to the nation's surprise, named Pittsburgh the best American city in which to live. In the past decade, Pittsburgh has quietly replaced its declining steel industry with high technology and service-related industries. Many of the remaining steel mills have been scaled down and are in the process of becoming automated. Financial services, high-tech manufacturing, and a strong tourist industry are turning New York's economy around. Further, the vast printing and publishing industry in the state is expected to grow by four percent this year.

The spread of high-tech industries in eastern Pennsylvania and southern New York should help offset the weakness of the traditional smokestack industries. Both Delaware and New Jersey's service and tourist industries are thriving. New Jersey is also home to a number of electronics firms, which expect average earnings to increase this year between 15 to 20 percent.

South Atlantic

District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, West Virginia

A good climate, low unionization, and access to major markets makes the South Atlantic region particularly attractive to manufacturers. Although once a mecca for manufacturers looking to escape high labor costs in the Northeast, low wages may not be what attracts manufacturers to the South Atlantic in the future. Wages are being driven higher by the influx of high paying, high technology jobs and labor shortages. Florida, Georgia, and North and South Carolina have all experienced increases in average hourly wages. Unemployment in the region stands at 6.4 percent, the third lowest in the nation, after New England and the Middle Atlantic. Per capita personal income has increased by 10.5 percent in 1984 compared to a national average increase of 9.7 percent.

Of all the states in the region, Florida and Georgia show the strongest economic growth. In Florida, in-migration is expected to boost the state's population, further strengthening housing and retail sales as personal income growth outpaces that of the nation. Defense spending will exert a powerful influence on the economy and should engender further growth in defense-related manufacturing. The agricultural sector in Florida, however, is suffering from an outbreak of citrus canker following two years of damaging freezes. As a result, imports from Brazil are taking a greater share of the state's $1 billion citrus industry.

Continued strength in transportation and wholesale trade will help Georgia's economy, increasing job creation by 5.2 percent this year. The restructuring of Georgia's textile industry will continue to burden the manufacturing sector. However, this may be offset by an extensive defense-related manufacturing industry whose growth prospects are good. Construction of the $1.4 billion Kings Bay Trident submarine base will continue to create new jobs. Similarly, the production of military airlift jets by Lockheed-Georgia in Marietta will boost employment in the state.

At present the South Atlantic region is laboring under the strain of its declining textile industry which has been devastated by stiff foreign competition. In the Carolinas, which account for 60 percent of the nation's textile employment, unemployment is expected to climb as 6,000 textile jobs are lost this year. However, the disappearance of several textile mills may, in part, be offset by the emergence of high-tech businesses in the area. Aided by higher cigarette prices and lower unit costs, the region's tobacco industry earnings are beginning to show a slight increase this year.

The mix of service-related industries in the region have provided some insulation from the employment declines that plagued its manufacturing-dominated economy. Florida has become a center for international banking, focusing on financial relations with Latin America. Companies in northern Virginia are snaring huge defense contracts, which along with tourism and services, are keeping Virginia's economy strong. Biotechnology, computer technology and service industries will contribute most of the 360,000 new jobs projected by 1990 in Maryland alone. In Maryland and North Carolina, the electronics equipment sector, primarily in communication gear, is estimated to grow by nine percent this year. The industrial chemicals and plastics industry has also grown considerably in West Virginia, South Carolina, and Florida.

Although West Virginia's steel industry may never reach previous levels of output, Weirton Works, now employee-owned, is once again in the black and has come to symbolize the industry's rejuvenation. However, coal mining has been stagnant for three years and no upturn seems to be in sight. Unemployment in the state is still the highest in the nation, standing at 11.6 percent as of May 1985.

East North Central

Illinois, Indiana, Michigan, Ohio, Wisconsin

The region's unemployment rate stands at 8.1 percent, the second highest in the nation. Combined with low growth in total employment and the nation's highest wage levels, the region's manufacturing labor costs are pricing industries out of their markets. Michigan's average manufacturing wage rate, at $12.68 per hour, is still a third higher than the national average. The state's unemployment rate stands at 9.8 percent.

Although the region is still tied to agriculture and smokestack industries, government officials and private industry leaders in the East North Central area are attempting to create an environment conducive to new business growth. A substantial recovery is clearly underway in the region's basic industries. Transportation and other machinery account for over a third of the manufacturing strength of the area and industry output is expected to increase by over four percent this year. Automakers are planning to maintain their ambitious third quarter production plans despite some weakness in sales and the recent Teamsters strike against car haulers. Moreover, several states are wooing foreign automakers to set up production facilities in their area. Honda Motor Company Ltd., Japan's third largest car company, has created hundreds of new jobs in its Marysville, Ohio plant. And Mazda Motor Corporation plans to have a car assembly plant, which will create more new jobs for the state, in operation by 1988 in Flat Rock, Michigan. The expansion of these auto plants should send welcome ripples throughout the region as related industries, including auto parts, chemicals, steel, and fabricated metals benefit from the increase in automobile production.

Prospects for steel manufacturing have increased as mini-mills boost output and productivity levels, but industry employment remains depressed. Another hard-hit industry is machine tools, but orders are expected to pick up this year in Wisconsin and Illinois. In order to make up for these lost jobs, the states are actively seeking foreign investors. In 1984, Japanese firms spent over $500 million in business ventures in Ohio. Rubbermaid Inc. of Wooster, Ohio, a producer of plastic housewares and industrial products, is setting up licensing agreements with Japan and other countries in order to boost sales. Unfortunately, contributing to the high unemployment rate are a number of industries which will see little or no growth. The food, and fabricated metals industries, which together comprise ten percent of the region's manufacturing jobs, are each expected to grow by barely 1.5 percent. Lower gasoline prices should boost Wisconsin's tourist industry but prospects for the farm sector are less optimistic. Its major product – milk – remains in excess supply and federal programs to support milk prices are scheduled to be cut.

The bright spot in the region lies in "Automation Alley," the Detroit-Ann Arbor corridor, which is on its way to becoming the robotics industries' equivalent of Silicon Valley. Of the estimated 60 robotics companies in existence, many operate out of this area. The rising fortunes of this sector should boost the earnings of related industries such as software companies, building vision sensors, and engineering services. Ohio is also participating in the robot revolution, with the recent joint venture between General Motors Corporation and Japan's Fanuc Ltd. and the well-established operations of Cincinnati Milicron.

A healthier economy is a safe prediction for this region. Part of the answer to the region's economic difficulties must be, over the long run, an increase in manufacturing productivity and a stronger competitive position *vis-a-vis* foreign producers. Since the region exports a large proportion of its manufactured goods, the weak recovery in our trading partners, combined with the strong dollar, have depressed foreign demand.

East South Central

Alabama, Kentucky, Mississippi, Tennessee

The East South Central region's economic outlook differs sharply among individual states and sectors. After surging forward early in 1984, the region's economy slackened in the summer when rising interest rates quickly depressed residential housing sales and construction activity. In response to lower demand, the region's lumber producing sector closed down a significant portion of its operations. At 8.3 percent, the region's unemployment rate is the highest in the nation. And, the region has the lowest hourly pay in the nation. Mississippi's economy lags the region's recovery, with unemployment standing at 9.3 percent.

The area's manufacturing activity depends heavily on the auto and housing sectors. Defense-related manufacturing, especially electrical and electronic machinery and equipment, should exhibit solid growth as should the region's paper manufacturing industry. However, the apparel and textile industries, especially in Alabama and Mississippi, have undergone a dismal year because of keen competition from imported products.

But, the textile industry is not the only sector troubled by intense foreign competition. The region's agricultural sector has also been beset by reductions in foreign demand. Low prices for farm products, heavy indebtedness, and persistently high credit costs remain major hurdles facing regional agriculture producers. The area's worst suffering industry is shipping, which may lose over four percent of total sales volume this year. In addition, the region's energy producing sector also remains depressed. The worldwide market for petroleum and natural gas is facing excess supply, depressed prices, and abundant capacity. Although some producers have slashed output to shore up prices, regional production of oil and gas cannot rebound until global market conditions improve.

Recently, General Motors Corporation picked the tiny town of Spring Hill, Tennessee for its $3.5 billion industrial complex to manufacture the Saturn – a venture that will create nearly 30,000 auto-related jobs within the state. GM joins Nissan Motor Company Ltd., Tabuchi Electric Co. of America, Bridgestone Tire Manufacturing of USA Inc., and a host of other Japanese and American companies that are making Tennessee an industrial mecca.

Kentucky, for years dependent on steel and coal, is undergoing an important transformation. Pike County – one of the state's fastest growing regions – is in the midst of one the biggest reconstruction projects ever undertaken in the nation, in an effort to provide more land for development. The state has also turned to the movie and television business in order to boost the economy; last year, film producers spent over $6 million on location in the state.

In sum, moderate economic growth is expected for the region this year. Not all sectors of the region's economy will participate in this growth but construction, services, and manufacturing of auto parts, building materials, defense equipment and paper should enjoy a good year. A recovery in exports will also mean expanding trade for the port cities of Alabama and Mississippi and their goods–chemicals, coal, rubber, and forest products.

West South Central

Arkansas, Louisiana, Oklahoma, Texas

Growth in the West South Central region will be modest this year as a result of the weakness stemming from the low demand for petroleum and petroleum-related products. With total employment rising slower than population growth, the unemployment rate actually increased by one percentage point to 7.9 percent this year. Both Arkansas and Oklahoma have unemployment rates above the national average and Louisiana's stands at 11 percent. However, the region's prospects are looking more favorable this year. According to the National Planning Association, Houston, Texas, expected to create over 1.2 million jobs by the year 2000, was singled out as the number one job generator in the country.

A tremendous construction boom in the region has now turned sour, with new home sales running 29 percent lower than in 1984. Though office construction lags in Texas, there are signs of new activity. The 20 percent vacancy rate in Houston shows signs of shrinking as office-leasing activity picks up. In durable manufacturing, growth should be seen in machinery, instruments, fabricated metals, and aerospace equipment which reflect the effects of increased government defense spending in the region. The government remains the aerospace industry's largest customer, accounting for approximately 70 percent of all new orders in 1984. As in other parts of the U.S., the region's strongest performers are defense and electronics industries. E-Systems, a Dallas defense electronics company, reported a record $1.1 billion backlog in orders near the end of 1984.

Both Louisiana and Texas have large percentages of their manufacturing output coming from industrial chemicals, which are expected to show strong growth this year. Texas produced goods and services worth about 7.5 percent of the nation's gross national product last year. Twenty-two percent of what the state produces is tied to energy and petrochemicals, making Texas five times more dependent on the oil and gas business than the country as a whole. Mining and extraction employment will continue to fall for the next few years, reflecting continued overcapacity for oil and gas drilling. Although Texas is expected to increase drilling activity, only token increases in demand for oil, gas, coal, and electricity will occur this year.

Louisiana's disappointing economic performance is linked to weaknesses in the energy, petrochemical and international trade sectors, as well as to a lower than expected boost from the World's Fair in New Orleans, which left a $120 million debt. However, growth can be seen in the Lake Charles area, currently competing for $100 million worth of construction contracts, which would create over 3,000 new jobs. Producers of wood products, such as Pacific Simpson, have reopened their mills in order to compete with foreign suppliers in the area of low-cost substitutes for plywood.

In Arkansas, officials are encouraged by the increase in nonenergy manufacturing firms, which have created 25,000 new factory jobs in the past two years. In Oklahoma, oilfield equipment manufacturing remains weak and the financial stress of the farm sector continues to put a damper on the economy. However, automobile production contributed a great deal to the state's manufacturing growth. With the exception of Texas, the fastest growing state in the region, the South Central states have been struggling to keep pace with the national economy. Indications are that while growth will be slow, it will be steady.

West North Central

Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota

Despite its increasingly diverse industrial base, the economy of the West North Central region continues to be dominated by agriculture. Farmers in the nation's heartland expect another year of low prices, excess production, mounting debts, and weak foreign demand. Even a big drop in the exchange value of the dollar would come too late to help agriculture in 1985. Of the major groups of wholesale food products, only fruit and vegetable prices rose over the last year. Prices of commodities produced in this region, including wheat, corn, milk, cattle, hogs, and poultry, have declined drastically, some by as much as 20 percent. Iowa, whose economy is very dependent on farming, had a 7.3 percent unemployment rate as of May 1985–an increase from last year of 0.5 percentage points. Although wheat and beef prices may increase slightly this year, major international competitors with the region are Argentina and Canada, whose currencies have declined relative to the dollar.

In this atmosphere, farmland values continue to drop. The Federal Reserve Bank of Kansas City reports that land in some areas is selling for less than $1,000 per acre for the first time since 1978. Since 1981, farmland value in South Dakota has dropped by as much as 19 percent while in Nebraska it has fallen by 35 percent. Farm debts in South Dakota average about $144,000 and the state's debt-to-asset ratio of 29.5 percent is second highest in the U.S., behind Nebraska. An estimated 4,500 of the state's 36,000 farms are going under; 5,000 have failed in the last five years.

Naturally, these farm bankruptcies have had a debilitating effect on farm equipment and supply companies and have forced several bank closures. Tractor sales declined about four percent last year and sales of combines, fell about 11 percent. Deere and Company, a farm equipment manufacturer, is laying off over 9,000 workers, while Allis-Chalmers laid off 530 workers at Independence, Missouri when it temporarily closed its combine plant. Caterpillar Tractor has also laid off workers in Illinois and Iowa. Companies, specializing in machinery for oil, construction, and farming equipment industries are in for a rough time this year.

However, gains in other sectors should boost activity in the area as nonfarm industries begin to account for a greater share of the region's output. Already, nonelectrical machinery – an industry group expected to sustain rates of growth over five percent this year – comprises over 15 percent of the region's manufacturing output. In addition, demand from the auto and defense industries for all types of machinery is expected to remain strong. In the high technology area, American Telemarketing Corporation and MidAmerica Long Distance Company started operations last year in Missouri, adding 2,200 new jobs to the economy. Construction, and automobile and aircraft plants operating in Missouri and Kansas provided the major impetus to those states' economies. Minnesota and South Dakota, with banking and high technology industries, led the region in job growth of about five percent last year. Nebraska, Missouri, and Kansas trailed close behind. Although the outlook for the region is for lower growth, it should be more manageable and more likely to guarantee healthy economies in the future.

Mountain

Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, Wyoming

Although the Mountain region's population density per square mile is low, dramatic demographic shifts are altering this as growth continues to advance. In fact, only the South Central states are growing faster. The unemployment rate stands at 6.8 percent, and total employment is expected to increase by three percent this year in the service and high-tech areas.

As long as oil prices remain under pressure and natural gas is abundant, the region's huge energy industries are likely to remain stagnant. As in Montana, Wyoming's oil, gas, and coal industries suffered reversals that have depressed employment in the trade and service support areas as well. Mountain area states, though traditionally heavily dependent on resource-extraction industries such as oil, coal, lumber, and mining are finding greater shares of their income coming from high technology sectors such as defense, computer and instrument industries. Arizona and Colorado, in particular, are now deriving over one-third of their manufacturing income from electronic, electrical and computer-related products, telecommunications, instrumentation and other high technology items. Indeed, about 1,300 high-tech companies have relocated to Denver in recent years. For example, Sperry Corporation is building a $13 million facility in Pueblo, Colorado, to make navigational computers for the military. Moreover, various companies are doing work for the $1.2 billion Consolidated Space Operations Center to be built at Colorado Springs. Such companies as Denver Aerospace, Martin Marietta, Brown Disc Manufacturing in Colorado and Intel in New Mexico are expanding their operations and the employment opportunities for the region as a whole.

In New Mexico, uranium mining was an important source of economic stability, but now the largest uranium employer, Kerr-McGee Corporation, is closing down its operations. Industry analysts claim that inflation, government regulation, overseas competition, and opposition to nuclear power were responsible for the downturn. Meanwhile, defense-related research keeps the economy strong. Almost three billion dollars are being spent each year in basic and applied research in the state, employing 30,000 people. And, even as Congress debates the "Star Wars" weapons-in-space program, the research into S.D.I. is underway. Another growth sector within the state has been the relocation of several branch plants of established electronics firms such as Intel, Motorola, General Electric and others, which have provided employment growth in excess of 20 percent over the past year. The combined effect of these activities has spurred increases in construction, services, and trade industries for substantial gains in employment.

Construction activity throughout the region is booming. In Utah, construction activity is 14 percent above levels reached in 1984 and in Arizona it is up 18 percent. Lumber and other construction-related industries in Montana and Idaho should, therefore, fare well this year.

The outlook for the nonferrous metals industry hinges on the continuing expansion in the auto and housing industries. The aluminum industry, which is beset with overcapacity and tough foreign competition, is now concentrating efforts on developing more sophisticated aluminum products and is in the process of diversifying into non-aluminum businesses. Foreign overproduction in copper mining has forced mine closings in Arizona, Utah, New Mexico, and Montana. Agriculture is bleak too, with wheat and beef producers continuing to be crippled by low prices, high interest rates and a strong dollar.

Pacific

Alaska, California, Hawaii, Oregon, Washington

No region in the country enjoys a better base for solid, long term expansion than the Pacific. From California to Washington, the region is banking on continued growth in electronics, aerospace and defense industries. The region also produces large quantities of oil, lumber, food, nonelectrical machinery, and instruments. The results of this highly positive industrial makeup are instantly apparent: the Pacific has the second highest rate of population growth, the highest job creation rate, and retail sales are among the strongest in the nation.

Oregon, best known for its lumber industry, has recently acquired the business of several Japanese electronic companies, which created over 13,900 jobs last year. As a result, the state will soon produce 25 percent of the world's silicone wafers. NEC Corporation, a Japanese electronics company, is building a $25 million factory for the production of fiber optics equipment; the West German-owned Wacker Siltronic Corporation has decided to build the world's largest polysilicon plant in the state; and National Semiconductor is laying the plans for a chip factory and an R&D facility in Portland. Oregon's lumber and wood processing plants may never return to previous operating levels, but electronics and electronics support businesses will contribute to the state's prosperity.

Washington's aluminum, wood-processing, and agricultural industries are all suffering from stiff foreign competition and oversupply. But the state has managed to keep its head above water by diversifying its economic base and welcoming over 350 electronics firms to the area, which contributed to the creation of 38,900 new jobs. A major source of manufacturing jobs in the region is the aerospace industry in Boeing's Seattle-area installations. Boeing increased its employment by 6,800 workers last year and if the company wins the contract to design the first manned space platform, an additional 1,500 jobs will be created.

Prospects for southern California's aircraft industry are also good. Long Beach-based Douglas Aircraft is benefiting from an American Airlines order for 67 MD-80 aircraft and a $438 million contract to develop the T-45, a new advanced Navy trainer jet. Rockwell International will hire 2,000 workers in the area, and Northrop Aircraft is also on the upswing. Defense-related expenditures will also contribute to the growth of electronics companies in Northern California.

Though growth in office-related industries is expected to be slow this year, computers still remain a strong sector. The overall gain of semiconductors and computers will be in the eight percent to ten percent range – half the pace of the last few years. For years, the famous high-tech Silicon Valley area provided jobs for about 2.5 million workers, but this year, signs of a slowdown are evident as electronics companies are reeling as a consequence of saturated markets and mushrooming foreign competition. Apple Computer laid off a fifth of its work force in a reorganization; Hewlett-Packard, facing unusually weak orders, mothballed most of its facilities for one to three days a month this summer; and Intel Corporation, one of Silicon Valley's most innovative semiconductor companies, is expected to lay off more than 1,000 employees. After phenomenal annual growth rates of over 20 percent, it is hardly surprising to see the pace of the computer industry slowing down.

The prospects for home building are the key to recovery of the vital timber industry in the region. Even as housing starts have turned favorable, market penetration by imports of Canadian lumber and the emergence of the Southern states as major suppliers of wood products, have hurt the Pacific Northwest. And, in Puget Sound, Washington, the shipbuilding industry is also in danger of losing work, with the Naval Shipyard trimming jobs as a part of a Navy cost reduction program.

The biggest sore spot on the region's horizon is farming. Hardest hit are rice and grape growers in California. But, fruit and vegetable producers in Hawaii and California are still commanding rising prices and should outperform other sectors. Despite soft oil prices, employment on the North Slope of Alaska should increase by seven percent because of drilling by Sohio and Arco at Prudhoe Bay. Tourism is still strong in Alaska as well as in Hawaii. With an eye to the future, all these states are striving to improve their business climate and economic growth in the region should remain strong.

DEVELOPING COUNTRY DEBT: WE ARE NOT OUT OF THE WOODS YET

by

Graciela Testa-Ortiz

The developing country debt problem, which erupted in 1982, has been successfully managed by most measures. Despite periodic rumblings (which recently intensified when Peru's newly elected president announced a ceiling on debt service payments and Fidel Castro hosted a conference on the issue urging the Latin American debtors to "cut out the cancer of debt"), the crisis atmosphere that prevailed three years ago has waned.

This article examines the current situation and the prospects for restoring growth and improving the debt service capability of the indebted developing countries. It finds that while progress so far seems to be encouraging, the resolution of the debt quandary will be a slow process, and that the problem is likely to remain with us at least through the end of the decade. Success in continuing to manage, and finally resolving it, depends significantly on the international economic environment during the next five years. Even more importantly, however, it depends on the ability of the indebted nations to affect the necessary policy adjustments which will ensure an environment of economic growth and political stability.

The Crisis: Recent Developments

For the developing countries, the external payments crisis was precipitated by the global economic developments of 1979-1982, including: (1) the second increase in oil prices; (2) the recessions of 1980–1982; (3) low commodity prices; and (4) rising interest rates. This combination of developments sharply reduced the volume and value of developing country exports while at the same time increased borrowing needs and debt service payments.

The worldwide economic recovery in 1983-1984 contributed to a marked improvement in the situation and defused the crisis atmosphere prevalent in 1982. World economic output rose by 4.3 percent last year, comparable to the average annual rate of growth that characterized the 1967-1976 period. More importantly, while output growth in the developing nations (3.7 percent), was considerably below the 6 percent average achieved in 1967-1976, it nevertheless represented a significant turnaround from the lackluster performance of the previous three years. Although the bulk of this improvement was largely the result of continued strong growth in the Asian nations, the economies of the major borrowers – Argentina, Brazil, Indonesia, Korea, Mexico, the Philippines, and Venezuela – enjoyed a 3 percent rise in output last year, following 3 years of very meager growth which included a recession in 1983. Moreover, those countries which recently experienced debt-servicing difficulties (namely, those which incurred external payments arrears or have had to reschedule their debt since 1981), also enjoyed a substantial turnaround in 1984 following two years of recession (see Table 1).

However, because the world recovery was not accompanied by a rise in commodity prices, the indebted nations did not benefit from the increase in foreign demand as much as they otherwise would have. The impact of weak commodity prices is reflected in the fact that, although the major borrowers enjoyed a 10 percent increase in the *volume* of their exports in 1984, the rise was nil in *value* terms. The continued weakness in commodity prices is not only associated with the dollar's appreciation since 1980, but also with technological improvements. For example, plastics are now being extensively used in construction where copper tubing was used in the past. This has resulted in a falloff in demand for copper despite the economic recovery. Another factor contributing to the current weakness in commodity prices is the increase in supply which resulted following the price boom of the mid-1970s.

The impact of external economic conditions differed in magnitude from country to country. For instance, the 1979 increase in oil prices is generally seen as a negative shock; however, this development was assuredly a plus for the oil exporting debtors. In some cases, it was a positive

TABLE 1
SELECTED INDICATORS OF RECENT ECONOMIC ACTIVITY

	1980	1981	1982	1983	1984
REAL GDP (% CH)					
Indebted Devoping Countries [a]	4.4	3.1	2.0	1.8	3.9
Major Borrowers [b]	4.7	1.8	0.4	-1.2	3.0
Countries with recent debt-serving problems [c]	3.9	1.1	-0.1	-1.9	2.0
FISCAL BALANCE (% OF GDP)					
Indebted Developing Countries	-2.9	-4.0	-4.9	-4.7	-3.8
Major Borrowers	-0.3	-3.0	-4.0	-3.1	-1.4
Countries with recent debt-servicing problems	-1.9	-3.8	-4.4	-4.0	-2.4
CURRENT ACCOUNT (US $B)					
Indebted Developing Countries	-77.0	-112.6	-102.9	-59.4	-37.9
Major Borrowers	-26.5	-35.7	-39.8	-10.9	-1.5
Countries with recent debt-servicing problems	-47.7	-66.7	-61.7	-25.6	-14.7
EXTERNAL DEBT (% OF EXPORTS)					
Indebted Developing Countries	110.4	123.3	148.0	157.9	151.3
Major Borrowers	175.2	187.4	240.9	254.9	236.6
Countries with recent debt-servicing problems	167.1	194.5	246.0	268.1	256.8
DEBT SERVICE (% OF EXPORTS)					
Indebted Developing Countries	17.3	20.9	24.6	22.2	22.5
Major Borrowers	29.8	35.4	44.3	35.8	35.1
Countries with recent debt-servicing problems	26.9	33.8	41.6	36.2	36.6

SOURCE: *World Economic Outlook*, International Monetary Fund, (4/85)

[a] Indebeted developing countries include all developing countries except the eight Middle Eastern oil exporters.

[b] Major borrowers are: Argentina, Brazil, Indonesia, Korea, Mexico, Philippines, and Venezuela.

[c] Countries that have experienced debt-servicing difficulties are those countries which incurred external payments arrears during 1981–1983 or rescheduled their debt during 1981–1984.

development of such magnitude that it offset the negative impact of weak foreign demand and high interest rates. Not surprisingly, therefore, the increase in oil prices had a positive impact on Mexico and Venezuela. Moreover, it did not create hardship for Argentina, a country which is energy self-sufficient (see Table 2).

In many cases, more than the shocks themselves, it was the domestic policy responses to the shocks which ultimately determined the extent of the debt problem faced. For example, the appropriate response to a rising oil import bill would have been an attempt to increase the international competitiveness of domestic products through, among other things, the maintenance of realistic exchange rates. This, in turn, would have buoyed exports, offsetting the deterioration in the balance of payments on current account (the current account represents flows of goods, services, and private transfers), occasioned by the increased cost of oil.

Table 2 compares the size of the external shock to the change in the current account and to capital exports in the seven largest Latin American countries. The data shows that none of the countries which experienced negative shocks completely offset their impact. Brazil made the greatest effort at adjustment as evidenced by the fact that its current account deteriorated by only $24 billion while the external shocks amounted to $49 billion. In Chile and Argentina, the effects of a worsening external environment were exacerbated by internal policies which resulted in a mounting current account deficit. The current account of both of these countries deteriorated by more than the negative shock. The outcome in the countries which experienced a net improvement due to the increases in oil prices is even more disappointing. In the case of Venezuela, although the current account improved by about as much as the positive shock, this was offset by a cumulative capital flight of $13 billion between 1979 and 1982. And despite enjoying a $12 billion positive shock, Mexico allowed its current account to deteriorate by almost $19 billion. This was further compounded by a $15 billion capital flight.

Signs of Success. . . ?

The International Monetary Fund (IMF) has played an important role in managing the debt crisis. In addition to providing bridge loans, it has recommended the enactment of austere macroeconomic policies in the indebted nations. These policies should be geared toward improving debt service ability by restoring growth and reducing the need for future borrowing. Austerity measures, however, can result in lower economic growth and thus, be extremely counter-productive in that they exacerbate debt servicing problems. In general, the goal of these policies is to reduce both the size of the government sector deficit and external imbalances. By these measures, the strategy appears to have succeeded. Table 1 shows that both central government and current account deficits have indeed declined.

However, reliance on the deficits as a measure of improvement fails to highlight how the so-called improvement has been accomplished. Government deficits can be reduced through declines in spending or increases in revenues. Declines in government spending reduce the level of government intrusion in the productive process and improve an economy's productive efficiency. However, raising revenues through increased taxation further reduces incentives to work, save, and invest. Thus, *how* the fiscal deficit is reduced, not just that a reduction has been accomplished, is of utmost importance. A reduction in the deficit that is accomplished through increased taxation will reduce productive efficiency, lower overall economic growth and worsen, not improve, a country's ability to service its debt. Bear in mind that many of the countries now experiencing difficulties already have high tax burdens. The top personal income tax rate in most of the Latin American countries

TABLE 2
SOURCES, MAGNITUDE AND EXTENT OF ADJUSTMENT/DISADJUSTMENT TO EXTERNAL SHOCKS FOR SEVEN LATIN AMERICAN COUNTRIES
(billions of dollars, 1979–1982)

Country	Terms of Trade		High Real Interest Rates	Low Export Demand	Total	Current Account Change [a]	Capital Export [b]
	All Trade	Oil					
Colombia	−4.3	−0.9	−0.9	−1.6	−6.8	−6.6	0.7
Brazil	−31.7	−17.9	−8.9	−7.9	−48.5	−23.6	−2.0
Chile	−1.9	−1.4	−1.5	−1.5	−4.8	−8.5	1.0
Argentina	−6.2	−0.6	−3.7	−3.6	−13.4	−18.9	−14.3
Peru	2.3	1.2	−0.8	−1.1	0.4	1.3	1.3
Mexico	22.5	21.0	−8.4	−2.4	11.7	−18.7	−15.2
Venezuela	24.0	29.4	−4.6	−0.3	19.1	19.5	−13.0

SOURCE: Enders and Mattione, *Latin America: The Crisis of Debt and Growth*, Brookings Institution, 1984.

[a] Adjusted for inflation.

[b] A minus sign denotes capital flight, i.e., an unfavorable movement in the relevant items of the capital account.

Note: A minus sign indicates an unfavorable shock. Totals are unadjusted for dollar inflation.

is over 40 percent, and is as high as 65 percent in Peru, and 70 percent in the Dominican Republic and Uruguay.

There is some evidence that the decline in fiscal deficits has, in fact, been accomplished through increased taxation. In Mexico, touted as a model of compliance with the IMF, the budget deficit was reduced through increases in taxes (sales taxes, for instance, were increased to 15 percent), and increases in the prices of goods and services produced by the government. Meanwhile, the already bloated government bureaucracy rose by 281,000 employees, more than the increase which took place in the previous six years. The same is true in Argentina where measures to reduce the government deficit have included increases in taxes on exports of wheat, corn, and soybeans. While these polices might raise government revenues, they will exacerbate trade deficits.

The extraordinary reductions in current account deficits of the indebted countries are also pointed to as an example of improvement. The major borrowers reduced their collective current account deficit by $38 billion in the past two years, from $39.8 billion in 1982 to only $1.5 billion in 1984 (see Table 1).

Unfortunately, this performance did not translate into a major improvement in the debt service ability of the indebted nations. There are three main measures of a nation's ability to repay its debt: the ratio of debt to total output (or gross domestic product), the ratio of debt to exports of goods and services, and the ratio of debt service payments (i.e., interest plus amortization), to exports of goods and services. Of these three measures, the last two are the most relevant since it is a nation's exports which allow it to earn the foreign exchange necessary to service and eventually repay, the debt. Thus, a nation with a vibrant and growing export sector can carry, without major difficulties, a debt burden (as measured by the ratio of debt to GDP), which another nation, with the same debt to GDP ratio but a lower rate of growth in exports may not be able to.

Table 1 shows that for all the indebted developing countries, debt service payments as a percent of exports of goods and services averaged 22.5 percent in 1984 compared to 24.6 percent in 1982. However, these overall figures hide the disparities between groups of debtors. While the Latin American and Caribbean countries shared in the improvement, the poorer African nations did not. Moreover, while the total external debt of the indebted developing countries has been rising at a slower rate since 1980 (11.6 percent per year between 1980 and 1984, compared to 23.4 percent per annum between 1977 and 1980), the improvement in these nations' ability to service their debt has not been impressive. As a percentage of exports of goods and services, the external debt of the major borrowers averaged 237 percent last year, an improvement over 1983 but still close to the 1982 average of 241 percent.

This outcome reflects a negative development which is hidden in the data for the current account. Namely, that the improvement in the current account has resulted from a substantial retrenchment in imports and, generally, has not come about through an increase in exports and thereby, has not resulted in an improvement in debt service ability. In the case of certain major borrowers, particularly those in Latin America, improvements in trade balances appear to have peaked approximately a year ago. In these countries, improved economic performance in 1984 and 1985 has been accompanied by a pickup in imports, while, with the exception of Brazil and Colombia, 1984 export growth remained below the rates achieved in 1964-73 and 1974-84. The data available so far for 1985 is even more disappointing (see Table 3).

TABLE 3
GROWTH IN EXPORTS
LATIN AMERICA vs. ASIA
(percent)

	1964-73	1974-84	1984	1985 [a]
Latin America				
Argentina	9.1	8.6	3.7	−13.4
Brazil	16.0	14.3	23.3	−6.0
Chile	9.0	10.4	−4.6	−5.3
Colombia	7.9	10.7	19.9	14.5
Ecuador	16.0	14.4	5.3	19.6
Mexico	8.8	23.4	7.8	−11.1
Peru	7.2	9.9	4.4	3.3
Venezuela	7.3	11.8	7.8	5.4
Asia				
Hong Kong	19.2	16.9	28.1	
Indonesia	16.5	19.8	10.8	
Korea	43.5	21.6	13.3	
Malaysia	10.8	16.6	17.3	
Philippines	11.2	9.8	7.9	
Singapore	12.4	18.8	10.9	
Thailand	13.0	15.2	16.3	

SOURCE: Morgan Guaranty Bank

[a] 1985 year to date, percent change from same period a year earlier. Jan–Apr: Brazil; Jan–Mar: Argentina, Chile, Ecuador, Mexico; Nov 84–Jan 85: Peru; Oct–Dec 84: Venezuela; Sept–Nov 84: Colombia.

Foreign Borrowing: The Key to Economic Development or a Recipe for Disaster?

The debt crisis has called into question the viability of reliance on external funds as a strategy for economic development. Recent experience has shown, quite dramatically, the potential for disaster lurking in excessive borrowing. Or has it? Are the difficulties encountered by the countries experiencing debt servicing problems the result of too much borrowing, of external factors beyond their control, or are other factors; namely, internal policy decisions, at work?

External borrowing can provide a developing nation with the funds necessary to pursue economic growth and concomitant increases in its standard of living. It can also aid an economy to adjust to temporary external shocks. The data shows that countries with similar debt to total output ratios may have entirely different debt service burdens, and further, that high ratios of debt to total output do not necessarily imply debt servicing difficulties. The factors which determine whether external borrowing is an asset or whether it eventually becomes a serious disadvantage are the domestic policies which accompany the increase in debt.

It is not a coincidence that the countries experiencing the most serious debt servicing difficulties are concentrated in Latin America, a region which has traditionally relied on a strategy of industrialization through import substitution behind trade barriers. On the other hand, market-oriented economies such as those of the Asian developing countries, have not experienced the same problems. For instance, both Malaysia and Chile have comparable (public) debt to output ratios—38.6 percent and 39.2 percent, respectively. However, the vast difference in their economic performance and their ability to service the same debt burden is clearly evident from their respective ratios of debt service to exports of goods and services. Chile's debt service payments reached 18.3 percent of exports in 1983 while Malaysia's was only 5.9 percent. Tables 3 and 4 compare the economic performance, in terms of output and export growth, and the debt burdens of Latin America and Asia. It shows that while the debt to GDP burden is, in some cases, comparable, the growth in total output and exports has been more vigorous in the Asian developing countries. As a result, the debt service burden of this group is much lower.

TABLE 4
FOREIGN BORROWING AND ECONOMIC DEVELOPMENT LATIN AMERICA vs. ASIA

	Real GDP Growth Rates			Ratio of Debt to GDP [a]	Ratio of Debt Service to Exports [b]
	1964-73	1974-84	1984		
Latin America				37.4	24.4
Argentina	4.0	0.8	2.0	32.1	24.0
Brazil	7.4	4.5	4.5	29.3	28.7
Chile	2.9	1.7	5.6	39.2	18.3
Colombia	6.2	3.8	2.5	18.3	21.3
Ecuador	9.5	4.5	2.2	63.0	32.5
Mexico	7.4	4.7	3.5	49.1	35.9
Peru	5.1	1.3	4.7	48.1	19.6
Venezuela	5.2	2.1	-1.7	19.8	15.0
Asia				20.7	9.8
Hong Kong	8.2*	8.1	9.0	0.8	na
Indonesia	11.8	6.5	4.6	28.9	12.8
Korea	10.8	7.5	7.5	na	12.3
Malaysia	7.1	7.2	7.3	38.6	5.9
Philippines	5.3	4.1	-5.5	30.4	15.4
Singapore	11.9	7.9	8.5	7.6	1.3
Thailand	7.6	6.6	6.0	18.0	11.3

SOURCE: Morgan Guaranty Bank and World Bank

na: not available
*1967-73

[a] Public debt as a percent of gross domestic product (1983 data).
[b] Public debt service payments as a percent of exports of goods and services.

Despite the deterioration of international economic conditions in 1979-1982, the majority of the developing countries have been able to continue to service their debt without interruption. An important characteristic of the nations which have not experienced financing problems is the application to which the borrowed funds are put. If the funds are utilized to finance an investment project which will ultimately improve the country's capacity to export, then the debt will not become as onerous a burden as if it is used to fund current consumption or large public projects which contribute little to export growth or real economic growth. In the first instance, both the debt to output and the debt to exports ratios would improve. In the latter instance, the debt to output ratio might improve, but the debt to exports ratio will deteriorate. This has been the experience of many African and Latin American countries which have undertaken large-scale investment projects in energy development, heavy industry and infrastructure which had low rates of return and were generally inefficient and uncompetitive.

Another important difference between the domestic policies of nations that experience problems and those that do not appears to lie with the degree of economic flexibility and the speed with which these nations have adjusted to external shocks. These, in turn, seem to be related to the extent to which the economy in question relies on the interplay of free market forces and the relative extent to which it is open to foreign trade and competition.

Domestic Policies of Problem Debtors

By and large, the Latin American nations relied on external borrowing to *avoid* rather than to facilitate the economic adjustments necessary following the first oil price shock. For the most part, these countries rejected the necessary pain of adjustment and followed a growth strategy based on import substitution and accumulation of foreign debt to deal with external imbalances. While the domestic policies which underlie the emergence of the debt crisis vary, the following are common characteristics: (1) expansionary fiscal and monetary policies resulting in galloping inflation; (2) overvalued exchange rates which reduced the competitiveness of exports and induced capital flight; and (3) increases in domestic investment not matched by increases in domestic savings.

These policies merit a more detailed discussion. Large central government deficits have resulted from a combination of excessive public sector investment and growing government consumption, as reflected in the large number of government enterprises. These are not limited to the creation of economic and institutional infrastructure, which can be legitimately considered the central government's responsibility. It also includes such economic sectors as transportation, utilities, financing, insurance, communications, trade and manufacturing, and the exploitation of mineral resources. The proliferation of state enterprises is indeed, vast. For instance, the Brazilian government has varying degrees of ownership in over 400 productive enterprises, and public enterprises comprise 9 of the 10 largest firms in that country. A measure of the extent of government intrusion in the productive process in Argentina is reflected in the fact that, in 1982, there were approximately 1.6 million people employed by the public sector, accounting for 26 percent of total employment for that year. Public investment projects in Turkey totaled 3,000 in 1976 and rose to 9,000 in 1980.

The widespread existence of government monopolies not only contributes to the creation of vast bureaucracies, but also to the misallocation of scarce resources, and reduced productive efficiency, which, in turn, result in lower rates of economic growth and lower living standards. The inefficiency of some of the public investment projects is truly amazing. The Peruvian government, for example, recently constructed an oil pipeline; however, this pipeline is bigger than the capacity of the country's oil fields. Peru has also invested heavily in agriculture, but the sugar complexes constructed have a unit operating cost which is three to four times the world price for sugar.

The resulting government deficits are financed through a combination of high levels of taxation, foreign borrowing, and money creation. Expansive monetary policy to finance government deficits is a prime cause of the hyperinflation many of these nations are now suffering. The broad monetary aggregates in the indebted developing countries have increased at average annual rates in the 30 percent to 50 percent range since 1977. The countries experiencing debt servicing difficulties allowed the monetary aggregates to grow by 85 percent in 1984, compared to a 21 percent increase in the developing countries not experiencing major problems.

This combination of policies led to a crisis of confidence reflected in the magnitude of the capital flight. Large scale capital flight, which has placed tremendous pressures on the balance of payments of some countries, results when the expected returns of holding money abroad are higher (or safer), than they are at home. This occurs when overvalued currencies increase the risk of future depreciations; when inflation is high, reducing real rates of return on domestic investment; and when financial policies at home attempt to maintain interest rates lower than inflation. Between 1979 and 1982, capital flight amounted to 137 percent of gross capital inflows in Venezuela, 65 percent in Argentina, 48 percent in Mexico, and 27 percent in Uruguay.

Trade policies have also reduced economic efficiency and economic growth in these countries. Fomenting growth through import substitution has hampered exports since a large proportion of Latin American exports are dependent on foreign inputs, which were restricted by all manner of tariff and nontariff barriers. At the same time, taxes on exports have been relatively high, for no apparent reason other than the fact that this appears to be a particularly easy tax to collect. The combination of trade barriers and currency overvaluation reduces the competitiveness of Latin American exports. Furthermore, the types of industries which have surfaced behind the protective barriers of these countries are not in a position to take advantage of international markets. The lack of international competition in a sheltered domestic market is not conducive to the development of efficient industries which are able to compete internationally.

Compare the outcome of these policies to that of the policies instituted by India in response to the first oil price shock. India, a low-income country, already had a sizeable debt to output ratio in 1974 and was in recession at the time. Rather than postpone adjustment through borrowing, Indian policy makers chose to reduce the fiscal deficit through increased taxes and reduced spending, and to control inflation through tight monetary policy. Domestic energy prices were allowed to adjust quickly to international levels. By 1978 the adjustment process was complete, and India became a net international lender enjoying a current account surplus. In the early 1980s, India was able to resume a growth strategy based on liberalized import controls and increased investment incentives.

While Latin America has the largest concentration of reschedulers of any geographic region and counts its four largest economies among the seven major borrowers, it is not alone in its misery. Poland and Yugoslavia have faced similar problems, although Yugoslavia has avoided rescheduling, thanks to a massive rescue operation by its major creditors in 1983. The domestic policies of these two countries prior to the onset of severe financing difficulties are strikingly similar to that of the Latin Americans, as state planning and state enterprises are common characteristics.

In Poland, an ambitious modernization effort was considered a prerequisite for political stability. In order to achieve rapid growth, Poland needed massive infusions of Western capital and technology; thus, external financing began growing in the early 1970s. The growth strategy involved a reorientation of trade away from the Eastern bloc toward the industrial West. Up until 1975 the strategy worked well; however, major policy mistakes became apparent thereafter. In the late 1970s, as trade deficits widened, import restrictions seriously affected Poland's exports because, as is the case with many Latin American countries, a large percentage of export industries are vitally dependent on foreign inputs. Yugoslavia has shared with the Latin American countries an emphasis on import substitution and currency overvaluation, as well as a dependence on imported intermediate goods. During the 1970s, Yugoslav exports shifted toward the Eastern bloc countries, while a large share of merchandise imports still came from the West, resulting in a widening bilateral trade deficit. Between 1973 and 1979 strong increases in domestic demand, led by growth in fixed investment, further diverted resources away from the export sector and placed additional pressure on the external account.

Early efforts at currency depreciation, in order to increase export competitiveness, which was being eroded by rising rates of domestic inflation, had the same results in Yugoslavia as they did in the Latin American economies. While the initial response was positive, depreciation eventually proved not to be enough as inflation continued to rise faster. The benefit of currency depreciation lies in the fact that it increases the competitiveness of domestic goods by making their price relatively cheaper in international markets. However, rising domestic inflation, by increasing domestic costs, can significantly erode international competitiveness, particularly if domestic currency depreciation is not used to offset this effect.

Finally, the structure of the foreign debt being acquired by the nations which are now experiencing the greatest difficulties has changed considerably and contributed to current problems. Two characteristics of the debt structure—the interest rate and the maturity—placed these nations in highly vulnerable positions. Ideally, loan maturities should match those of the investment projects being funded, and which are expected to generate the necessary income to repay the debt. The increase in the proportion of short-term debt to total debt was, therefore, a clear recipe for disaster since the debt became due before the investments yielded the income with which to repay it. The proportion of debt incurred at floating interest rates also rose markedly. As a result, high nominal and real interest rates have significantly increased debt service burdens.

Managing the Debt and Restoring Growth

In spite of the decline in capital flows since 1981, the outstanding debt of the major borrowers reached $360 billion in 1984, compared to $129 in 1977. Moreover, total debt has risen, not fallen, over the past three years. What needs to be done to turn this situation around?

External Factors

The global economic environment during the next five years will play an important role in the eventual outcome of the debt problem. The ideal situation would include the following events: (1) strong and uninterrupted economic growth in the West; (2) declining interest rates; (3) strengthened commodity prices; (4) the industrial nations significantly open up their markets to developing country exports.

Analysts have attempted to quantify the impact of external economic conditions on economic growth and debt in the major debtor nations. Table 5 shows the sensitivity of economic performance in the major seven Latin American debtors to a positive external environment. A one percentage point increase in economic growth in the industrial nations would increase real GDP growth by 1.7 percentage points and reduce the debt by $15 billion by 1987.

TABLE 5
SENSITIVITY OF ECONOMIC PERFORMANCE TO EXTERNAL ECONOMIC CONDITIONS FOR SEVEN LATIN AMERICAN COUNTRIES 1983 TO 1987

Conditions	Debt [a]	Real GDP [b]	Debt to Exports Ratio [c]	Current Account Deficit [d]
Base Case	342.9	5.6	252.3	6.5
Increased Demand in OECD Countries	327.5	7.3	228.2	1.6
Decreased Interest Rates	331.2	6.4	244.2	4.5
Increased Oil Prices	334.1	6.0	237.3	4.0
Improved Terms of Trade	319.8	5.7	222.9	0.6

SOURCE: Enders & Mattione, *Latin America: The Crisis of Debt and Growth*, Brookings Institution, 1984.

[a] 1987 Foreign debt outstanding in billions of dollar.
[b] Growth (percent change) in real GDP between 1982 and 1987.
[c] 1987 Debt to exports ratio (percent).
[d] 1987 Current account deficit as a share of exports (percent).

Note: The base case reflects IMF stabilization programs, i.e., the countries are assumed to follow policies of fiscal and monetary restraint. The increased demand alternative assumes that growth in the industrial nations is one percentage point higher relative to the base. The decreased interest rates alternative assumes that interest rates are 100 basis points lower. The increased oil prices scenario assumes oil prices are ten percent higher. The improved terms of trade scenario assumes that the price of nonoil commodity exports is one percentage point higher.

Unfortunately, this rosy scenario is becoming increasingly unlikely. The U.S. economy is already halfway through its third year of expansion, and as can be expected at this stage of the economic cycle, growth is slowing. In spite of the fact that we anticipate U.S. economic performance will stage a comeback during the second half of 1985, it would be unrealistic to expect the very high rates of growth experienced during the first year and a half of recovery. A slowdown in U.S. economic growth, at least when compared to recent experience, would not be a cause for concern if growth in Europe and Japan were to pick up the slack. However, while Japan shows a great deal more vigor than the European nations, the likelihood of their combined economies staging a vigorous upturn is slim. Econometric evidence suggests that a rate of growth of 3 percent in the OECD nations is necessary in order for the debt problem of the developing countries to remain manageable. Current OECD forecasts call for a 3.3 percent increase in 1985 and a 2.8 percent increase in 1986, barely enough to remain within the "manageable" threshold. Thus, assuming that there will not be a recession in the industrial nations over the next five years, the best that can be hoped for is the same rate of increase in demand for developing country exports as we are now experiencing. Thus the debt problem will be manageable, but not resolved.

The outlook for interest rates is slightly more optimistic. As measured by the London Interbank Offered Rate (LIBOR), interest rates have fallen by 400 basis points over the past year. For the Latin American nations, a sustained 100 basis point decline in interest rates would imply a 0.8 percentage point increase in economic growth and a $12 billion decrease in the debt by 1987 (see Table 5). However, commodity prices, and in particular oil prices, are expected to remain weak. While low oil prices are an unambigous plus for the industrial economies as well as for the oil-importing developing countries, the net impact of low oil prices on all the indebted countries is negative. Of the seven major borrowers, three (Indonesia, Mexico, and Venezuela) are oil exporters, and one (Argentina) is self-sufficient in energy. Therefore, continued weakness in oil prices will have a decidedly negative effect on the first three nations, and no significant impact on Argentina.

Domestic Policies

The external environment during the remainder of the decade can, at best, be expected to be moderately supportive to the developing countries. However, the problem will not be solved, future crises will not be avoided, and growth will not resume in the indebted nations unless their governments commit themselves to the types of policies which have been so successfully applied in Asia. Constancy and continuity in policy implementation are also imperative, as adjustment, of necessity, requires some short-term sacrifices. This has not been achieved in the Latin American nations. Although earlier efforts at liberalization did prove beneficial in terms of increasing the rate of growth in exports, they were short-lived, lasting only three years in Mexico and Argentina, four years in Chile, and six to seven years in Brazil and Colombia.

Econometric simulation studies and the experience of the Asian countries show that a major effort at stimulating growth through expanded exports, as opposed to an investment-led recovery, would yield the greatest benefits. Investment-led growth would not be very successful, particularly since capacity is already underutilized. Thus, there is little incentive to expand investment, especially if there are no signs of rising future domestic demand. Further, the large dependence on foreign inputs implies that increased investment would result in deteriorating trade balances and an increase, rather than a reduction, in the accumulation of debt. Once an export-led recovery is underway, however, a switch toward increased investment might be appropriate, especially to the extent that it can lead to additional production for export.

The Latin Americans allege that slow export growth, particularly in relation to the Asian performance is due to external factors related to their dependence on particular trading partners and products, and protectionism in the industrial West. The data, however, does not bear out this claim. In fact, for Latin America as a whole, exports to industrial countries account for 66 percent of total exports, not significantly different from the Asian experience where the comparable ratio is 63 percent. The major market for both groups of nations is the United States. As a result, market orientation does not explain their poor export performance. Protectionism in the industrial West did not place the Latin American economies at a greater disadvantage than that of the Asian developing countries. An IMF study shows that protectionism has had a greater negative effect on Asian exports than on Latin American exports.

Their dependence on commodity exports does explain relatively more of their lackluster export growth because commodity prices have remained weak. However, with the exception of Brazil, the Latin American nations did not embark on a concerted effort of promoting nontraditional exports. As a result, exports of manufacturers comprised only 16 percent of total exports in 1980-82 compared to the Asian countries' 54 percent ratio.

Spiraling inflation in Latin America is the most painful evidence of the failure of macroeconomic policies. Fiscal and monetary policies should be focused toward reigning in inflation and promoting exports. To that end, a long, hard look should be given to government spending policies. Privatization of government enterprises would go a long way toward reducing government spending and improving efficiency. Reductions in government subsidies would not only help reign in government spending.

High tariff and nontariff barriers have also contributed to the proliferation of inefficiencies as well as powerful interest groups. Even more damaging to efforts at raising foreign exchange and diversifying exports are the relatively high levies on exports. These types of policies only exacerbate trade deficits and offset benefits derived from exchange rate adjustments, thus reducing international competitiveness. Moreover, a few countries (e.g. Chile), fail to provide duty-free imports of intermediate products to exporters, further hindering export growth. In fact, according to a recent study by Morgan Guaranty Bank, protective barriers sheltering local economies in much of Latin America stand higher today than before the onset of the debt crisis.

A prerequisite for a strong export performance is maintenance of a realistic exchange rate. Unfortunately, in many indebted developing countries, particularly in Latin America, a strong currency is a matter of national pride rather than a policy tool to promote exports, and thus, economic growth. Overvalued currencies distort, and in some cases, have offset the impact of liberalized trade policies. As a result, production becomes biased in favor of domestic markets, imports rise, and capital flight is encouraged. Many nations resort to credit and exchange controls in order to deal with the capital flight problem when the appropriate, market-clearing policy would be currency depreciation. Such policies only ensure that capital will not be repatriated. The problem of capital flight can only be solved through the maintenance of realistic exchange rates, the removal of credit controls so that rates of return on domestic currency investments will keep pace with inflation, and assurances that such funds will not be subject to confiscation and freezes, or unduly taxed. The issue of capital flight begs the question of the quality of economic growth being purchased by increased indebtedness. It also raises the issue of the advisability of international financing and rescue efforts to increase the flow of capital from abroad when national citizens are removing their assets from the country.

A new influx of foreign investment would go far in providing the developing countries with badly needed capital, technology and managerial know-how. However, many of these countries place tremendous roadblocks in the way of foreign investors by restricting the proportion of foreign ownership in certain industries, restricting access to domestic credit markets, failing to provide a stable economic environment, and generally making their markets inaccessible to foreign investors.

Unfortunately, most of the liberalization policies which sound eminently sensible – the removal of trade barriers, dismantling of government subsidies to consumption and inefficient industries, privatization of government enterprises, realistic exchange rates, and opening up markets to foreign competition – will provoke the anger of entrenched interest groups and pose a real danger to the political stability of many governments, particularly the fledging Latin American democracies. We have already seen instances of resistance to the IMF-imposed austerity measures in Brazil when widespread riots occurred in 1983 in Sao Paulo and Rio de Janeiro. It is worth noting that this unrest occurred when the military were still in power in Brazil and that such instances of political violence under a military regime are quite uncommon occurrences. The point was ludicrously emphasized in Argentina in late 1983 when a local judge jailed Argentina's central bank president on charges that debt renegotiation agreements into which he had entered on behalf of his country violated local law. These instances are not limited to Latin America; work stoppages also occurred in Yugoslavia in reaction to government austerity measures which included the reduction in government subsidies on flour and bread.

However, Latin America, with its vast human and natural resources, is in a much better position to withstand the pains of adjustment than are the poorer African nations which are also facing debt problems. In order to mitigate the adjustment process and make the medicine more palatable, "a spoonful (or two) of sugar" is needed. This should take the form of additional net lending by the creditor nations and multilateral organizations such as the IMF, but also the World Bank and regional development banks such as the African and Inter-American Development Banks. The continued availability of long-term financing at lower interest rates (including, in some cases, at concessionary terms), will go a long way toward making possible the enactment of macroeconomic policies that will spur a resurgence of export growth, and by definition, overall economic growth and rising standards of living in the indebted developing countries. It must be emphasized, however, that additional lending is not the solution. It merely recognizes that in many countries the socio-political costs may be too burdensome and additional lending may be necessary to facilitate the adjustment process. However, lending should not take the place of adjustment.

Conclusion

Policies supportive of the adjustment process in the indebted nations are in the best interest of the United States. The benefits to the United States are not limited to issues of national security, but also of economic well-being. The concentration of nations with debt servicing problems in the Western Hemisphere speaks to both of these concerns. The trade flow between the United States and Latin America is truly a two-way street. Not only is the U.S. the major market for Latin American exports, but their economies are a major source of demand for U.S. goods and services. In fact, Mexico (together with Canada and Japan), is one of the three largest markets for American exports.

In its zealousness to protect American jobs from foreign competition, many legislators and interest groups have lost sight of the fact that the retrenchment of Latin American imports since 1982 has cost thousands of jobs in U.S. export and export-related sectors and regions. Border cities and towns in Texas, for instance, suffered along with the Mexicans from the austerity measures needed to deal with the debt problem. The real estate and tourist industries in Florida also felt the impact. And port cities such as Miami, New Orleans, and to a lesser extent Baltimore, major points of entry and departure for trade with Latin America, also suffered from the reduction in that trade. In testimony before the Joint Economic Committee of Congress, University of Pennsylvania Professor F. Gerard Adams noted that the U.S./Latin American trade balance suffered a $23 billion deterioration between 1981 and 1984. The deterioration mainly affected the manufacturing sector, including such industries as primary metals and motor vehicles. Reduced import demand on the part of the Latin American economies reduced real GNP in the United States by $19 billion, resulting in the loss of 800,000 jobs.

It should be evident from the foregoing that the most important requirement for the resolution, or at least, the longer-term management, of the debt problem resides in cooperation and understanding between the debtor and creditor nations. Both groups have much to lose from the unraveling of the process in which they are now embarked.

A major commitment to the ideals of free trade by both groups of nations will go a long way toward solving the problem. The right set of macroeconomic policies in the industrial nations will not only improve the outlook for their domestic economies but also provide the stimulus that the debtor countries need. Just as importantly, however, major domestic policy adjustments are needed in the indebted developing countries. Finally, an increase in net lending, at longer maturities and lower interest rates, will be necessary to mitigate the short-run adverse impact of adjustment in the debtor countries.

TRENDS IN COMMERCE
NOTES ON TABLE II
SEPTEMBER, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—Gross National Product—the value of the output of goods and services—grew at a 2.0 percent annual rate in the second quarter, compared to a 0.3 percent growth rate of the first quarter. Personal consumption, residential investment and business investment grew rapidly while government purchases showed a smaller gain. Exports declined in the second quarter; however, there was no change in imports. In addition, real net inventory investment increased by only $8.3 billion compared to $19.1 billion in the first quarter.

The Services Sector—The services industries continue to be the growth sector of the economy. Comparisons between recent growth in the services sector and growth in goods underscore the dramatic differences in the trends. Employment in service sector establishments rose by 0.3 percent in July and is now 4.3 percent above its year-ago level. This compares with virtually no change in employment in the goods producing sector in July and a 0.7 percent increase in the last year.

Consumers continued to increase spending on services despite a lackluster performance in the goods sector. July data indicate that while retail sales were up 5.7 percent from their levels of last year, consumer expenditures on services soared by over 10 percent over the same period. Consumer purchases of services now comprise 51.1 percent of personal consumption expenditures compared to 49.8 percent in July 1984. In the past year, nearly 70 percent of the current dollar increase in personal consumption expenditures was for services, with less than one-third of the rise being attributable to increased outlays for goods. One rapidly expanding service has been travel. Revenue passenger miles flown, that is the number of passengers multiplied by the miles flown by each passenger, increased 5.3 percent in May from April, and was up nearly 15 percent from its level of last May.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.8 percent in July, only about one-half the rate registered in June. The money supply, in the latest three month period, has been growing at a 14.4 percent seasonally adjusted annual rate. This is far above the Federal Reserve's target range of four to seven percent.

Employment—The civilian unemployment rate remained unchanged at 7.3 percent in July for the sixth month in a row. Civilian employment—as measured by the monthly survey of households—increased by 492,000 persons (seasonally adjusted) after declining by 590,000 from May to June. However, the number of jobs in July, before seasonal adjustment, increased by over one million. The reason for the stagnant rate of unemployment is the continued flow of new entrants and reentrants into the labor force that swells the ranks of the unemployed. However, the number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 243,000 in July, reflecting the continued strength of service sector and construction employment.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.2 percent in July for the third consecutive month. The components of change were significantly different in each of the months. The May index rose primarily due to an increase in the housing component, which was offset by declines in food, apparel, and transportation. The June index showed price advances for a broader range of goods, with a much smaller gain in the housing component. The July index showed the largest increase in the other goods and services category due to a 1.6 percent increase in the cost of tobacco products, while gasoline prices declined 0.4 percent, after five months of increases. The pace of increase in consumer prices slowed to a 2.5 percent annual rate in the latest three month period, significantly below the 4.1 percent rate in the first quarter.

Wholesale prices of finished goods increased 0.3 percent in July, and were up only 0.9 percent from their year ago level. The index for energy prices turned down for the second consecutive month after substantial increases in April and May, while capital equipment prices were unchanged following a 0.4 percent increase in June. From July 1984 to July 1985, the finished goods index increased by only 0.9 percent. This increase is one fourth the 3.6 percent increase in consumer prices in the last twelve months, reflecting the fact that the Producer Price Index only measures the goods sector of the economy, while the Consumer Price Index measures both goods and services.

Crude goods prices declined in July for the eighth consecutive month. The July decline of 0.3 percent in crude materials prices was the smallest price drop within this volatile sector during the year. Crude materials prices in July were 9.1 percent below their level of a year ago. Crude food and feedstuff prices have fallen 12 percent in the last year. Prices of crude energy material are 5.2 percent below their year-ago levels and nonfood materials, excluding energy, are 6.9 percent below their levels of last year.

Housing Starts—Privately owned housing units were started at a seasonally adjusted annual rate of 1,654,000 in July, down 2.4 percent from the June level. So far, there has been no sign of the surge in new housing starts that many analysts were predicting would result from the decline in interest rates. In addition, building permits, usually an indicator of future activity in the home building industry, declined one percent in July.

Industrial Production—Industrial production data was recently revised back to 1967. The long run effect of the change was very slight. The revised data showed that between 1967 and 1984, industrial production increased by 3.0 percent instead of the 2.9 percent previously estimated. The data also indicated that the current recovery was slightly stronger than was previously estimated. The original data indicated a 22.5 percent increase in manufacturing output from the bottom of the last recession in November 1982 to May 1985. This compares to a revised 23.6 percent gain for the same period. July data showed a 0.2 percent increase in both manufacturing output and total industrial output compared to 0.3 percent in June. The sector that had registered strong gains in recent months, defense and space products, declined 0.3 percent in July, but the slack was made up by increased output of consumer durables. Production of consumer goods was up 0.3 percent in July, reflecting a gain in both durable and nondurable goods production. Automobiles were being assembled at an 8.3 million unit annual rate in July, up from 8.0 million units in June. Business equipment production fell 0.3 percent in July following a 0.2 percent decline in June. Previous data indicated that business equipment production had declined 1.3 percent in the first five months of the year, while the latest data shows an increase of 2.7 percent.

The capacity utilization data was also revised, along with the data on industrial production. Capacity utilization in manufacturing was unchanged in July as factories operated at 80.4 percent. Both primary metals and automobile manufacturing showed utilization rate gains of about three percent for the month. This brought the utilization rate for these industries back to their levels of earlier in the year. However, most industries showed small losses. Manufacturing capacity increased 0.8 percent in the second quarter of 1985 and was 3.3 percent above the second quarter of 1984.

Productivity—Nonfarm business productivity increased at a 1.0 percent annual rate in the second quarter, compared to a 3.1 percent decline in the first quarter. The productivity decline in the first quarter resulted from an increase of 3.7 percent in hours worked while output rose by only 0.5 percent. The fact that hours worked expanded seven times as fast as output in the first quarter may be indicative of problems in measuring the output of the growing services sector rather than a slowdown in output. The combined effect of more people at work, working longer hours and a small increase in output, caused unit labor costs in the nonfarm sector to soar at a seasonally adjusted annual rate of 8.4 percent in the first quarter. In the second quarter, output in the nonfarm business sector grew by 2.2 percent, and the number of hours worked increased by 1.2 percent.

Interest Rates—At 9.5 percent, the prime interest rate is 3.5 percentage points below last summer's peak, and out of the double digit range for the first time in nearly seven years. However, during July, most interest rates began to trend back up. The federal funds rate ended July about half a point higher than at the beginning of the month, and most long and short-term Treasury bill rates were between 0.3 and 0.4 percentage points higher during the same period.

Business Failures and Formations—Total bankruptcies, according to Dun and Bradstreet, increased to 27,471 in the first six months of 1985, this was two percent more than the number of bankruptcies in the same six months of 1984. Dun and Bradstreet's Index of Business Failures indicates that business failures declined in mid-July and were at their lowest level since March. The index of business failures, which uses October 1983 as a base of 100, decreased to 97.7 in the week ending July 12, 1985. In addition, business discontinuances and business closings were also trending downward in mid-July, each falling about six percent in the last month.

Dun and Bradstreet reported that 635,000 new business corporations were formed in 1984, an increase of 5.8 percent from the previous year. Fifteen states had increases of ten percent or more, and eight of the nine census regions reported more new business incorporations in 1984 as compared to 1983. The only region reporting a decrease in business corporations was the West South Central, while the New England region reported the largest annual gain with an increase of 11.5 percent in 1984, twice the national average. The states reporting the largest increases in new corporations for 1984 were Vermont, Georgia, and South Carolina. The number of new business corporations formed in December 1984 was 53,305 (seasonally adjusted), 3.8 percent more than the same month a year earlier. Ten states registered increases of more than ten percent from their year-ago levels in December, with Vermont, New Jersey and Arizona reporting the largest increases.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	May/85	238.6	238.4	236.5	0.1	0.9
Gross National Product ($B)	II/85	3,855.1	3,810.6	3,644.7	1.2	5.8
Gross National Product (72$B)	II/85	1,671.5	1,663.5	1,638.8	0.5	2.0
Money Supply (M1) ($B)	Jul/85	595.9	591.2	546.9	0.8	9.0
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Jul/85	2,520.5	2,510.1	2,350.5	0.4	7.2
Personal Consumption Expenditures (72$B)	Jun/85	1,105.1	1,104.6	1,071.0	0.0	3.2
Disposable Personal Income ($B)	Jul/85	2,708.4	2,696.3	2,589.0	0.4	4.6
Disposable Personal Income (72$)	Jun/85	1,187.1	1,222.1	1,172.4	−2.9	1.3
Personal Savings Rate (%)	Jun/85	4.3	5.0	5.6	−0.7[b]	−1.3[b]
Civilian Employment (millions)	Jul/85	106.9	106.4	105.4	0.5	1.4
Civilian Unemployment Rate (%)	Jul/85	7.3	7.3	7.5	0.0[b]	−0.2[b]
Average Hourly Earnings	Jul/85	$8.57	$8.57	$8.35	0.0	2.6
Consumer Price Index (All Urban, 67 = 100) [a]	Jul/85	322.8	322.3	313.0	0.2	3.6
Purchasing Power of the Dollar (67 = $1.00) [a]	Apr/85	0.310	0.311	0.321	−0.186	−3.44
Prime Interest Rate (%) August 31, 1985		9.5	9.5	13.0	0.0[b]	−3.5[b]
Retail Sales ($)	Jul/85	113.7	113.3	107.6	0.4	5.7
SERVICES SECTOR						
Employment in Services (Millions)	Jul/85	72.7	72.4	69.8	0.4	4.2
Consumer Purchases of Service ($B)	Jul/85	1,288.7	1,281.8	1,171.1	0.5	10.0
Consumer Purchases of Service (72$B)	Jun/85	513.2	509.4	490.0	0.7	4.7
Revenue Passenger Mileage Flown Major Airlines (Millions) [a]	May/85	26,610	25,269	23,204	5.3	14.7
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	II/85	221.1	222.3	246.0	−0.5	−10.1
After Tax [a]	II/85	136.5	137.0	150.2	−0.4	−9.1
Industrial Production (67 = 100)	Jul/85	124.9	124.7	123.2	0.2	1.4
Capacity Utilization Rate (Mfg.) (%)	Jul/85	80.4	80.4	81.7	0.0[b]	−1.3[b]
New Housing Starts (thou. units)	Jul/85	1,654.0	1,694.0	1,730.0	−2.4	−4.4
Net Business Formation (67 = 100) [a]	Jun/85	115.4	112.2	117.0	2.9	−1.4
New Business Incorporations (Thousands)	Dec/84	53.5	53.5	51.6	0.0	3.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	II/85	164.5	163.3	157.6	0.7	4.4
Unit Nonlabor Costs (77 = 100)	II/85	161.2	160.3	156.8	0.6	2.8
Producer Price Indices (67 = 100)						
Crude Materials	Jul/85	301.6	303.3	331.3	−0.6	−9.0
Intermediate Goods	Jul/85	317.8	318.8	320.9	−0.3	−1.0
Finished Goods	Jul/85	294.0	293.5	291.8	0.3	0.9
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Jun/85	544.4	611.0	542.7	−10.9	0.3
Federal Government Debt Outstanding ($B) [a]	Mar/85	1,715.1	1,702.8	1,468.3	0.7	16.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	II/85	349.4	360.7	362.4	−3.1	−3.6
Imports of Goods & Services ($B)	II/85	442.8	435.2	421.1	1.7	5.2
Balance on Goods & Services ($B)	II/85	−93.4	−74.5	−58.7	25.4	59.1
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Jul/85	168.7	168.0	163.9	0.4	2.9

NOTES: All data seasonally adjusted unless otherwise noted
[a] Not seasonally adjusted
[b] Percentage point difference

Federal Spending–The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased 4.1 percent in June from its year-ago level, about the same as the inflation rate. However, in the first nine months of fiscal year 1985, federal expenditures increased by 10.9 percent, nearly three times as fast as prices, indicating a real increase in federal spending of about seven percent from the year-ago level. Federal receipts, during the same period, have risen by 11.3 percent as a result of double digit increases in personal income taxes, corporate income taxes, and social insurance taxes. The data on tax receipts indicates that the deficit is the result of excessive growth in federal outlays rather than the 1981 tax cuts. This shows the futility of seeking to cut the deficit by means of even higher taxes. If the federal deficit is growing at a time of economic expansion and double digit increases in federal tax receipts, then any attempt to raise tax revenue even further will result in total abandonment of efforts to control federal outlays.

Personal Savings–Personal savings increased from 4.5 percent of after-tax income in the first quarter to 5.3 percent of after-tax income in the second quarter of 1985. The reason for this increase in the savings rate in the second quarter was that the tax refunds which were delayed in the first quarter of the year finally reached consumers in the second quarter. On a monthly basis the personal savings rate peaked at 6.2 percent of after-tax income in May when the IRS was mailing out tax refunds at a feverish pace to meet the May 31 deadline and avoid paying interest to taxpayers. Since May the savings rate has dropped almost by half from 6.2 percent of disposable income to 3.4 percent in both June and July.

Retail Sales–Retail sales increased 0.4 percent in July following a revised decline of 1.4 percent in June, which had earlier been reported as a 0.8 percent decline. Retail sales for the latest three month period were up 5.3 percent from the previous three months, indicating that the sales increase over the latest three months is at more than a 20 percent annual rate. Durable goods sales rose 0.7 percent in July, after declining 1.3 percent in the previous month; nondurable goods sales inched up 0.2 percent after falling 0.7 percent in June. The bright spots in the retail sales report were the gains in department store sales, up 2.2 percent, and hardware store sales which showed a 5.0 percent increase for the month.

Trade Deficit–The trade deficit continued to grow in the second quarter. On a goods and services basis, the trade deficit increased to $93.4 billion in the second quarter from $74.5 billion in the first quarter. The deterioration is in large part due to an $11.3 billion decline in nominal exports, while nominal imports increased by $7.4 billion. On a monthly basis, the merchandise trade deficit declined by $2.9 billion in July to $10.5 billion, following three successive months of widening deficits. The decline was mainly due to a lower level of imports while exports remained unchanged. Petroleum imports decreased 19.3 percent as a result of a 91 cents per barrel drop in oil prices and a lower volume of imports. Other categories of goods reporting lower levels of imports in July were automobiles, iron and steel plates and sheets, and telecommunication equipment. The value of July exports was virtually unchanged from June.

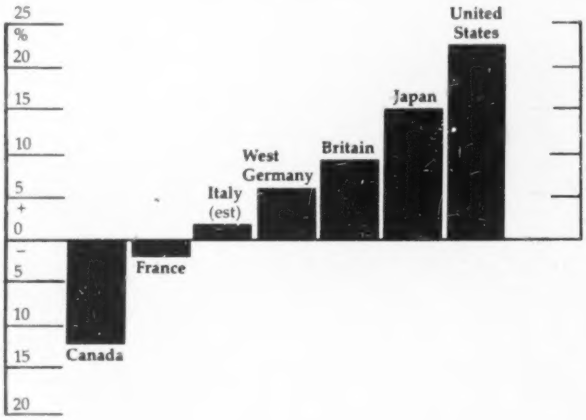
What's Ahead–The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.4 percent in July, with six of the eleven available indicators up, three were down and two were unchanged. This follows a revised 0.4 percent increase for the month of June that was previously reported as a 1.0 percent gain.

UNITED STATES IS THE LEADER IN BUSINESS FIXED INVESTMENT

For the past two years, business investment has been growing in America, Great Britain, and Japan. As the chart shows, American companies, stimulated by new tax breaks, invested more and earlier than in previous economic recoveries. On the other hand, British companies have invested for the opposite reason: to use capital allowances that were about to be phased out. Japanese companies continue to maintain a steady investment trend.

Among some of the other OECD countries, Canadian investment was discouraged by low commodity prices. French investment has barely risen for the last ten years, but West German companies are spending again.

Business fixed investment
percent change in volume
1983 & 1984



Source: Organization for Economic Co-operation and Development

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States
October 1985

THE U.S. ECONOMY: BRIGHTER DAYS AHEAD

by
Richard W. Rahn and Graciela Testa-Ortiz

In last month's assessment of the economic outlook, we noted that despite a disappointing first half, a growing number of positive signals suggested that the economy was poised for a turnaround. With the release of more complete data for August and September, the signs of improvement are becoming unmistakable. Moreover, indicators which foreshadow movements in overall economic activity, including the index of leading indicators, are pointing to renewed strength in the months to come. The leading index, designed to predict economic activity six months in advance, rose by 0.7 percent in August, following a similar increase in July, for the seventh increase this year. The series is now 1.1 percent above its 1984 peak. Other indications of stronger growth in the months ahead, discussed in greater detail below, include manufacturers' orders, building permits, and employment.

Recent Recovery Experience

Now entering its fourth year, the current recovery seems to have already become one of the three longest recoveries in postwar history, ranking behind the 1960 and 1975 expansions. Moreover, on the inflation and job creation fronts, the current episode is performing better than the 1960 and 1975 recoveries. Although civilian employment rose faster during the third year of the 1975 recovery, this was accompanied by double digit rates of growth in consumer prices. And, while the 1960s was a period of low inflation, job creation was significantly slower than this time around.

While concern continues to be expressed regarding the weakness experienced during the first half of 1985, Table 1 shows that compared to the previous five upturns which lasted this long, real gross national product rose at an average rate during the third year of recovery. In fact, a closer look at the data reveals that had it not been for our deteriorating trade balance, real GNP growth would have been substantially stronger than average. Most components of GNP, with the exception of net exports and

TABLE 1
SELECTED ECONOMIC INDICATORS
RECOVERY EXPERIENCE[1]
(percent)

	First Year	Second Year	Third Year
Real GNP			
Average	4.3	5.4	4.3
82:3 to 85:2	0.8	6.7	4.2
Consumption			
Average	3.2	4.2	3.8
82:3 to 85:2	2.4	5.8	4.2
Nonresidential Investment			
Average	2.7	7.5	6.4
82:3 to 85:2	−2.3	15.5	13.7
Equipment			
Average	3.5	9.5	7.1
82:3 to 85:2	−0.4	20.3	13.7
Structures			
Average	1.7	4.4	4.9
82:3 to 85:2	−6.3	4.6	13.7
Residential Investment			
Average	10.1	5.5	4.9
82:3 to 85:2	17.8	33.4	1.6
Exports			
Average	2.9	9.9	8.2
82:3 to 85:2	−10.0	2.5	0.7
Imports			
Average	5.4	9.9	7.5
82:3 to 85:2	−2.4	22.4	17.4
Industrial Production			
Average	5.7	7.5	6.9
82:3 to 85:2	−0.6	13.3	5.8
Civilian Employment			
Average	1.0	2.7	2.3
82:3 to 85:2	−0.3	3.8	2.9

[1] First year is average of first four quarters of recovery compared to recession trough. Second and third years are four-quarter averages compared to previous period.

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residential investment, grew at rates significantly above average in the twelve months ending with the second quarter. Moreover, once the GNP benchmark data revisions are completed at year-end, growth will likely be shown to have been even stronger. Due to the heretofore faulty estimation of investment in computers, the revision is anticipated to add as much as $86 billion to total GNP in 1984.

Consumer Spending: Domestic Autos

The flash estimate of third quarter GNP anticipates a 2.8 percent annual rate increase over the second quarter. Led by spending on automobiles, the consumer sector continues to be the major source of strength. Domestic car sales reached an annual rate of 9.7 million units in August, a seven year high. This was followed by another record in September as sales for the month averaged 11.3 million units, bringing the average for the third quarter to 9.5 million. This will be reflected in a strong showing for overall consumer spending during the quarter. In fact, the Department of Commerce anticipates that, once the numbers are all in, consumer and government spending will be the only components of GNP showing increases during the third quarter; investment and net exports are expected to remain flat.

While this is good news for the quarter just ended, and may even lead to an upward revision of the data later this month, it could diminish consumer durable spending during the fourth quarter. The surge in car buying was in response to aggressive marketing efforts, particularly below-market financing. Those incentives have come to an end now and the fourth quarter begins with the introduction of the higher-priced 1986 model year cars. Industry estimates place the average price increase for 1986 models, when account is taken of higher financing charges, at nine percent. While General Motors and Ford have already introduced a below-market financing plan for certain 1986 models and other automakers are expected to follow suit, buyers may still balk at the 1986 price increases. Further, it is likely that the car buying spree of the past few months may have cut into fourth quarter sales. The result is likely to be a depressed fourth quarter for spending on consumer durables.

Housing

Data on housing and construction are mixed. While total construction spending increased strongly in August, this was from a depressed July level. Sales of existing homes jumped by nine percent in August and are now 24 percent higher than they were in August 1984. Although the monthly growth rate in sales of new single-family homes is lagging behind the growth in sales of existing homes, it remains 26.5 percent above its year-ago level. As a result, the surge in existing home sales should continue to feed into new home sales and housing starts in the coming months. Housing starts posted an increase in August, rising by 6.2 percent to an annual rate of 1.75 million units. This places the average for the first two months of the quarter at only 1.7 million units—a disappointing outcome given recent improvements in housing affordability. The National Association of Realtors' Affordability Index reached 94.8 in August, its highest level in six years. This reading of the index indicates that a median income family has 94.8 percent of the qualifying income necessary to buy a median priced resale home with an 80 percent conventional mortgage. The strong sales performance for existing homes, continued affordability improvements, low housing inventory, and building permits which have remained in the 1.7 million to 1.8 million unit range during the past four months, presage added strength for the housing industry.

Exports and Imports

An encouraging development has become evident in the data for the foreign sector. During the past nine months the rate of growth in U.S. imports of goods and services has slowed markedly (see Chart 1). While this performance mirrors the slowdown in the overall economy, other factors seem to be at work as well. Some analysts point to the fact that the slowdown in import growth may be tied to inventory problems. As businesses attempt to keep a handle on inventories they are finding that they can do so more successfully by buying from domestic sources whose lead times are shorter and delivery schedules more flexible.

CHART 1
REAL IMPORTS OF GOODS AND SERVICES
(year-ago percent change)

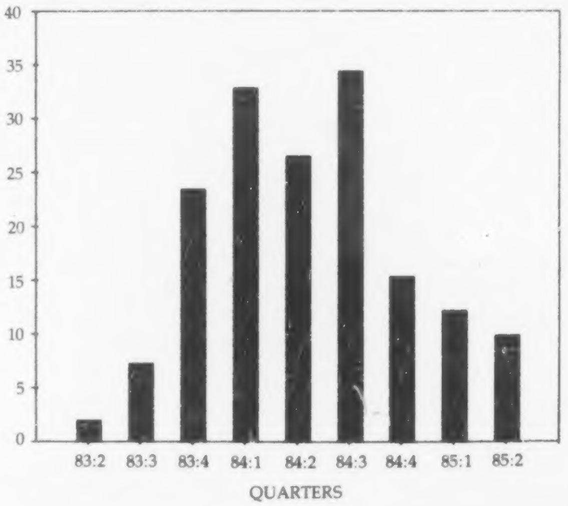

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1987
Prepared by the U.S. Chamber of Commerce
Percent change from previous period at a seasonally adjusted annual rate

	QUARTERS									YEARS			
	Actual		Forecast							Actual	Forecast		
	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	0.3	1.9	2.8	4.1	3.9	4.0	3.6	3.9	4.4	6.8	2.5	3.7	4.0
Consumption	5.2	4.9	4.8	2.6	3.0	2.2	2.3	2.1	2.8	5.3	4.2	2.9	2.2
Residential Investment	5.5	6.1	5.8	4.1	9.5	1.5	0.7	3.6	3.0	12.2	1.8	4.8	-2.4
Business Fixed Investment	-1.5	14.4	0.3	1.9	8.0	6.3	8.8	8.6	7.8	19.8	6.8	6.1	7.3
Equipment	-5.6	16.7	0.5	2.2	8.7	7.3	10.0	9.0	7.7	21.5	6.1	6.8	7.0
Structures	9.8	8.8	-0.2	1.2	6.2	3.9	5.8	7.5	8.0	15.6	8.7	4.2	8.0
Exports	-8.9	-15.2	4.7	3.8	5.8	7.8	10.0	13.5	17.1	4.7	-3.8	5.2	18.3
Real Net Exports (72$B)	-33.8	-34.2	-34.2	-35.3	-34.2	-32.9	-30.2	-26.7	-23.4	-15.0	-32.9	-31.0	-11.0
Imports	32.2	-0.7	4.5	5.7	2.0	3.2	1.8	3.0	6.5	27.0	7.7	3.1	3.9
Government Purchases	0.6	-0.3	5.1	5.9	5.5	4.4	4.1	2.4	1.9	3.5	6.9	4.6	2.1
Real Final Sales	-0.3	4.6	4.0	2.4	4.1	3.0	3.7	3.7	4.0	5.0	3.4	3.5	3.7
Industrial Production	0.7	2.0	2.4	6.1	5.3	6.0	5.6	6.5	7.2	10.6	2.8	5.1	6.5
Change in Business Inventories (72$B)	19.1	8.3	3.8	10.9	10.2	14.1	13.9	14.5	16.0	24.8	10.5	13.2	18.5
New Car Sales (total, mill.)	11.3	11.5	12.8	11.8	12.0	12.0	12.0	12.0	12.1	10.5	11.8	12.0	11.6
New Domestic Car Sales (mill.)	8.5	8.2	9.7	8.6	8.7	8.5	8.4	8.4	8.4	8.0	8.7	8.5	8.0
New Housing Starts (total, mill.)	1.8	1.8	1.8	1.9	1.9	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.7
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.3	7.1	6.9	6.7	6.6	6.5	6.4	6.2	7.5	7.2	6.6	5.8
Compensation	5.0	3.3	3.8	3.8	4.7	4.5	4.5	4.7	5.2	4.2	3.9	4.3	5.0
Productivity	-3.3	1.1	-0.1	1.8	1.1	1.3	1.0	1.2	1.4	2.7	0.1	1.1	1.2
Unit Labor Costs	8.3	2.1	3.9	2.1	3.6	3.2	3.6	3.5	3.8	1.4	3.9	3.2	3.8
Consumer Price Index	3.3	4.2	2.7	3.8	4.3	4.3	4.6	4.7	5.1	4.3	3.5	4.1	5.0
Implicit GNP Deflator	5.4	2.6	3.1	3.3	3.2	3.5	3.6	3.8	4.6	3.8	2.7	3.3	4.3
Prime Interest Rate (%)	10.5	10.2	9.5	9.5	9.5	9.3	9.3	9.4	9.4	12.0	9.9	9.4	9.7
3-mos. Treasury Bill Rate (%)	8.2	7.5	7.1	7.0	7.0	6.8	6.9	7.0	7.1	9.5	7.4	6.9	7.4
Corporate Bond Rate (%)	12.3	11.6	11.0	10.8	10.5	10.2	10.0	9.8	9.7	12.7	11.4	10.1	9.7
Profits from Current Production ($B)*	207.0	214.9	209.0	216.1	217.9	225.1	227.3	233.8	243.5	195.9	211.8	226.0	302.4
GOVERNMENT FISCAL POLICY ($B)**													
Unified Receipts										666	725	790	860
Unified Outlays										842	920	980	1045
Unified Deficit										-176	-195	-190	-185

*After-tax corporate profits with inventory valuation and capital consumption adjustments.

**Unified budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macroeconometric model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revision to the National Income and Product Accounts for the second quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to enact a deficit reduction package which results in a static reduction in federal government outlays of $44 billion in 1986 and $68 billion in 1987. The nation's money supply, as measured by M(1), rises by 9 percent in 1985, 8.5 percent in 1986 and 6.9 percent in 1987. The federal minimum wage remains at $3.35 per hour throughout the forecast interval. The price of a barrel of imported crude oil averages $25 in 1986 and $23 in 1987 compared to $28.9 in 1984. The trade-weighted exchange value of the dollar rises 2.6 percent this year on a year-over-year basis. During 1986, it falls by 21 percent, but rises 2.1 percent in 1987.

Unfortunately, however, the performance of U.S. exports leaves a great deal to be desired. Even as import growth has slowed, the net exports gap has widened because export growth has slowed as well. Excluding the foreign sector from measured GNP shows that domestic demand has remained remarkably strong, rising by 3.1 percent during the second quarter of this year over its year-ago level, while total GNP rose by only 2.3 percent over the same period.

This month's forecast assumes a continued improvement in the trade balance. After growing by 27 percent last year, real imports are expected to rise by only 7.7 percent this year, 3.1 percent in 1986, and 3.9 percent in 1987. Real exports are also anticipated to recover, leading to a reduction in real net exports. This outcome is based on optimistic assumptions regarding the value of the U.S. dollar in foreign exchange markets. The weighted average exchange value of the dollar is estimated to decline by 25.6 percent by the last quarter of 1987 compared to its peak during the first quarter of this year.

Our assumption regarding the decline in the value of the dollar is based on an analysis of economic fundamentals rather than the impact of the announced foreign exchange market intervention. In fact, the dollar's value declined by 12 percent between February and September 1985, prior to the intervention announcement. The explanation lies with the apparent synchronization of economic performance and prospects here and abroad. During 1983 and 1984, not only was the U.S. recovery substantially stronger than in Europe and Japan, but prospects for a significant upturn abroad were meager.

During the past year, however, the economies of our major trading partners have strengthened. Industrial production rose by 4.1 percent in Canada, 4.5 percent in West Germany, 5.9 percent in Japan, 5.8 percent in Sweden, and 4.5 percent in the United Kingdom, compared to 1.1 percent in the United States. Moreover, although real interest rates (three month interbank rates adjusted for consumer price increases), fell in eight of the 12 largest economies between mid-1984 and mid-1985, the most rapid decline occurred in the United States. In mid-1984, real interest rates in the United States were on a par with Great Britain's and lower than only Australia's and Canada's. By the middle of this year, most of the major economies–Australia, Sweden, Italy, Canada, Great Britain, Japan, Holland, and France–had higher real interest rates than the United States. Stronger growth and higher real rates of return abroad would tend to reduce the attractiveness of dollar-denominated assets and contribute to the decline in the dollar's value. This trend is expected to continue, particularly since the late September announcement by the industrial nations included a pledge on the part of our trading partners to further stimulate their economies.

Despite the efforts of the industrialized nations to push down the value of the dollar through coordinated intervention in foreign exchange markets, we do not believe that the intervention itself will be responsible for the dollar slide. Foreign exchange intervention is notorious for its ineffectiveness. History is replete with cases of unsuccessful intervention episodes whose only result, in the last analysis, is to cost government treasuries billions of dollars while currency values, as expected, continue to respond to economic fundamentals. To be sure, intervention can be shown to have a limited, short-run impact, but in the long run, economic fundamentals will always prevail.

In the past, foreign exchange intervention was geared toward moving currency values in the *opposite* direction of their natural tendencies, i.e., attempts were made to stop a currency's depreciation, for instance. Now, efforts at lowering the value of the dollar come at a time when it is already declining on its own accord. If, as we believe, economic fundamentals were already such that the dollar was on a downward trend, intervention will accelerate that decline.

The improvements in the U.S. trade balance that will be brought about by a depreciation in the value of the dollar will not be felt immediately. History shows that the lag between changes in currency values and net exports is sometimes as much as two years long. As a result, export growth will not accelerate markedly until 1987.

Business Investment

In spite of the unprecedented strength of business investment during the past three years, the outlook for this sector is frought with uncertainty. In the short run, low capacity utilization and poor profits performance are likely to sap some of the sector's previous vigor. The capacity utilization rate inched up one-tenth of a percentage point last month to 80.5 percent, still below the 82 percent recovery peak reached last year. And corporate profits, though improved during the past quarter, are anticipated to post a weak showing during the third quarter. As a result, the Department of Commerce has estimated that third quarter business investment will show almost no growth. The fourth quarter, however, should show an improvement. Automakers expect a 3.7 percent increase in output during the fourth quarter aimed at restocking inventories and shipping new models. Industry estimates are that about eight million cars will be built in 1986.

Although shipments of nondefense capital goods increased in August, surveys continue to show a scaling down of investment plans. A recent Conference Board survey of the nation's largest manufacturing corporations showed a 4.5 percent decline in new appropriations during the second quarter and a sharp decline in projected new investment for 1985. We expect that business fixed investment will rise by 6.8 percent this year compared to almost 20 percent in 1984.

On a more positive note, manufacturers' orders rose by 0.9 percent in August and the National Association of Purchasing Management, in its monthly survey, reported strong growth during September. The Association's composite index surged last month to 51 percent, the first reading above 50 percent in nine months. When the index, which is based on such indicators as new orders, production, speed of suppliers filling orders, inventories, and employment, exceeds 50 percent, it is viewed as an indication of economic expansion. Further, the percentage of survey respondents who said that production had improved during September, increased for a third consecutive month, reaching 23 percent compared to only 14 percent in July.

Moreover, several major industrial sectors still require new spending on efficiency-improving plant and equipment in order to effectively compete against foreign producers in domestic as well as international markets. Also, the depreciation of the U.S. dollar will improve the competitiveness of traditional export firms as well as open up new export opportunities for other industries and firms. As a result, business investment is expected to continue to be a growth sector.

Conclusion

The best indication of the underlying strength of the nation's economy continues to be its remarkable ability to create new jobs. During the past 34 months, payroll employment has risen by 8.5 million, an average of 250,000 new jobs each month. With the leading indicators, new manufacturing orders, and building permits all pointing up, real GNP is expected to rise by 4.1 percent during the year's last quarter, averaging a 2.5 percent increase for the year as a whole. During 1986, the economy is expected to grow at over 3.5 percent per quarter (annual rates), posting a 3.7 percent increase for the year.

The major risk to the outlook is the uncertainty surrounding threats of tax reform. Tax reform has certainly become a major threat to U.S. business investment and is probably having a strong influence on the scaling down of investment plans. In the July/August issue of ECONOMIC OUTLOOK we reported that analysis of the so-called Treasury II tax reform proposal showed that less generous depreciation allowances and repeal of the investment tax credit would so increase the rental price of investment in producers' durable equipment that the net result would be to offset the incentives resulting from a reduction in the statutory corporate tax rate. Now, the House Ways and Means Committee has unveiled another proposal whose treatment of depreciation is even worse than under Treasury II, essentially returning depreciation lives to the Asset Depreciation Range in effect prior to the enactment of the Economic Recovery Tax Act in 1981.

Tables 2 and 3 compare the impact on the U.S. economy of the House Ways and Means proposal. The rental price of investment in business equipment, residential building, and consumer durables is expected to rise significantly, with investment in producers' durable equipment and single-family housing bearing the brunt of the increase (see Table 2). As a result, equipment investment is anticipated to be $91.5 billion lower by 1990 (five year cumulative loss), than would have been the case under present law. Total housing starts are expected to be lower

TABLE 2
IMPACT OF HOUSE WAYS & MEANS PROPOSAL ON THE RENTAL PRICE OF INVESTMENT
(Percentage Difference from Base)

	Years from Implementation				
	1	2	3	4	5
Business Capital					
Equipment	15.4	15.3	14.9	14.7	14.4
Structures	0.5	−1.0	−1.5	−3.0	−3.5
Residential Buildings					
Single Family	8.2	9.0	8.4	7.0	6.4
Multi Family	6.6	5.9	5.4	4.1	2.8
Consumer Durables	1.4	1.4	1.0	0.5	0.5
Inventories	1.7	0.0	−4.0	−6.1	−11.1

Source: Washington University Macroeconomic Model

TABLE 3
IMPACT OF HOUSE WAYS & MEANS PROPOSAL ON THE U.S. ECONOMY

	Years from Implementation					Cumulative Impact
	1	2	3	4	5	
GNP						
Billions of 72$[1]	−6.5	−19.2	−30.4	−43.9	−58.0	−158.0
Percent[2]	−0.4	−1.1	−1.7	−2.4	−3.1	
Consumption						
Billions of 72$	1.4	−2.7	−8.2	−16.4	−27.3	−53.2
Percent	0.1	−0.2	−0.7	−1.4	−2.2	
Nonresidential Investment						
Billions of 72$	−3.8	−12.4	−20.7	−29.1	−35.8	−101.8
Percent	−1.7	−5.5	−9.3	−12.4	−14.9	
Equipment						
Billions of 72$	−3.6	−11.3	−18.7	−26.1	−31.8	−91.5
Percent	−2.2	−7.0	−11.7	−15.3	−18.0	
Structures						
Billions of 72$	−0.4	−1.2	−2.0	−3.0	−4.1	−10.7
Percent	−0.6	−1.9	−3.2	−4.7	−6.5	
Residential Investment						
Billions of 72$	−4.8	−6.6	−5.9	−5.6	−5.9	−28.8
Percent	−7.3	−10.1	−9.4	−7.9	−8.0	
Exports						
Billions of 72$	−0.1	−1.0	−2.3	−3.8	−5.6	−12.8
Percent	−0.1	−0.7	−1.6	−2.6	−3.7	
Unemployment Rate						
Percentage Point Difference	0.3	0.6	0.8	1.3	1.6	
Housing Starts						
Millions of Units	−0.3	−0.2	−0.2	−0.2	−0.2	−1.2
Percent	−13.8	−12.6	−10.9	−10.5	−11.5	
Domestic Car Sales						
Millions of Units	−0.1	−0.2	−0.3	−0.5	−0.7	−1.8
Percent	−1.6	−4.4	−5.7	−9.1	−12.7	

[1] Difference from base in real (1972) dollars.

[2] Percent difference from base.

Source: Washington University Macroeconomic Model by 1.2 million units over the five year period. The impact on gross national product is substantial. By 1990, real GNP would be 3.1 percent lower and the unemployment rate would be 1.6 percentage points higher than would otherwise have been the case (see Table 3).

This proposal is only a recommendation of the House Ways and Means Committee staff and will undergo many modifications before a final tax reform bill is enacted. As the legislative process continues, the U.S. Chamber of Commerce will work hard to ensure that the legislation which finally emerges will enhance rather than hamper capital formation and economic growth.

Hopefully, Congress and the Administration will either devise an alternative pro-growth tax reform package or drop the entire effort. It would be tragic if the tax reform concept which could have a very positive impact on future U.S. economic growth is so distorted as to turn into an instrument of economic destruction.

AMERICAN AGRICULTURE AT THE CROSSROADS

by
Rajni Bonnie Ohri

American agriculture is considered one of the most successful examples of agricultural development in the world. Agricultural industries, from farming to food processing to the retailing of farm products, constitute the largest sector of the U.S. economy, accounting for 20 percent of gross national product. The 2.5 percent of the civilian labor force involved in agriculture produce enough to feed the entire domestic population and still account for over 20 percent of our total export earnings. Today, the U.S. is the largest agricultural exporter in the world.

Despite these measures of success, the U.S. agricultural economy is going through its most difficult period since the Great Depression, and the problems there are having important repercussions on the rest of the economy. With commodity prices depressed, farmland values plummeting, and export markets shrinking, the economic viability of many farmers is imperiled. Although financial stress among farmers has grown in terms of incidence and severity during the 1980s, less than ten percent of the nation's 2.4 million farmers are actually insolvent or on the verge of bankruptcy. Indeed, according to the Department of Agriculture, 83.4 percent of U.S. farms are financially sound. The problem, however, is centered among middle-sized commercial farmers who hold a disproportionate share of the nation's farm debt. Their solvency is directly linked to the health of rural America where banks, businesses, farm suppliers, and local governments rely on the farmers for their primary market.

Farm Difficulties are Far Reaching

By any standard, the past four years have been a time of unprecedented pressure on the prices of a wide range of basic commodities. Although the 1981-82 recession lowered commodity prices 10 to 35 percent, most of these declines were reversed during the initial stages of the current expansion. By mid-1984, however, the commodity price indexes began to decline once again, with prices 15 percent lower at the end of 1984 than at the peak reached during this expansion. The steep rise in the U.S. dollar, the sluggish world recovery, and the unexpectedly good agricultural harvests worldwide have provided the main impetus to the decline in commodity prices.

This catastrophic price situation has left U.S. farmers in a difficult position. Domestic markets are not large enough to consume their bumper crops and surpluses are being added to massive government stockpiles of unsold agricultural commodities from previous years. These large increases in supply relative to demand are exerting additional downward pressure on farm prices. Corn is now selling for $2.32 per bushel down from $3.36 in June 1984; soybeans which sold for $8.12 per bushel in May 1984 have sunk to $5.22. Thus, the current farm problem is one of overproduction (leading to lower commodity prices and lower farm income) which becomes acute in the agricultural sector because one year's mistakes are stored and added to those of the next. In 1981, for instance, U.S. farmers produced a record 15.6 million bales of cotton, but only 11.8 million were sold. Carry-over stocks from 1981 have been plaguing the cotton market ever since. In 1983, cotton production was down to 7.7 million bales and demand was up to 12.7 million, but because the year began with 8 million bales in storage, cotton supply exceeded demand by almost 25 percent. Today, the price of cotton is about what it was in 1976.

When foreign demand also declines, the cumulative effects of overproduction become especially painful. Roughly four out of ten acres are planted for foreign sale. Farm exports, which totaled $7 billion in 1970 rose to $44 billion in 1981. But exports have fallen off since then and are estimated at $38 billion this year. Sixty percent of the wheat, 50 percent of the soybeans, and 33 percent of the corn crops grown by U.S. farmers are exported. If foreign customers fail to buy, as has lately been the case, there is nowhere for the crops to go but into storage, because the U.S. already has all the food it needs. As a result, many farmers with excess supply will turn over their crops to government stockpiles.

The crop surpluses have also taken their toll on farm income. Agricultural analysts estimate that the falling commodity prices could reduce net farm income to $22 billion this year, 36 percent less than what it was in 1984. And as farm prices and incomes fall, so will the value of farm assets, including land.

The farmers' difficulties are also hurting nearly all businesses that service them. The food and fiber industry, the economy's largest sector, employs about 22 million workers in various agribusinesses. The Federal Reserve Bank of Kansas reports that one-fifth of nonfarm businesses in rural communities are experiencing financial stress. Local merchants claim that farmers are buying less machinery, fertilizer, gasoline, and pesticides. Excess supply can be seen most dramatically at the tractor and combine-making plants of firms such as John Deere, which are operating at only 55 percent of capacity, or in the unused processing mills of Archer Daniels Midland, one of the world's largest food companies. Steiger Tractor Inc., which has lost over $5 million on sales of $66 million this year, has had to cut its staff and curtail operations. Local governments (especially in Nebraska and Iowa) are also pinched. With farm income depressed and declining land values reducing property assessments, revenues are drying up and public services are being curtailed.

Outdated Farm Policies

Part of the current farm problem can be traced to the present federal farm programs which originated in the 1930s as the government's response to persistent economic problems in the sector. In 1930, 22 percent of the labor force was employed in farming and produced 9 percent of the national income. Now, the farm sector employs less than 2.5 percent of the U.S. civilian labor force and generates 2.6 percent of the national income. Farming has become an increasingly specialized, capital-intensive, high-technology business. Between 1930 and 1980, farm production grew by 140 percent while employment in agriculture declined by 80 percent. The increase in labor productivity and in turn, farm family income, was achieved through improved technology and an increase in the use of land and capital.

Throughout their history, farm programs have reflected the notion that farm-income problems are caused by *temporary* imbalances in supply and demand. Thus, there has been a succession of short-run government programs designed to deal with the economic conditions in agriculture at the time legislation was written. These short-run responses have been at the expense of an integrated farm policy that would facilitate long-term adjustments to the forces of change generated by new technology and market conditions. Today's agriculture programs have the dual objective of price stability and income enhancement. In their simplest form, these programs have established minimum support prices through the use of crop loans, direct payments, and direct purchases of products, and are supplemented by various types of voluntary (subsidy-induced) or mandatory supply reduction programs.

Farmers' income is subsidized in two ways. The first is to peg income to so-called loan rates (a target price for the product, not an interest rate), which guarantee that when prices fall below a certain level the government will buy the crops. In effect, the loan rate is a minimum, government guaranteed price. The second is through deficiency payments, which are direct cash subsidies to prop up farmers' incomes. The deficiency payments are pegged to pre-set "target prices," which assure farmers the income they would have received if market prices were at target levels.

In addition, farmers receive several other benefits from the government, such as government subsidized interest rates, federally funded farm research programs, and special tax provisions. Farming also benefits from price boosting import tariffs and quotas, marketing orders, resource conservation programs, customs revenues and food assistance sent abroad. Yet even at this elevated level of government support, segments of farming are suffering.

In 1981, when Congress enacted the current farm bill, it was looking back on one of the most prosperous decades that American farmers had ever experienced. Prosperity on the farm meant relatively little spending on farm programs: federal farm spending averaged about $3 billion a year prior to 1981. Farmers' overseas markets were expanding rapidly and farmers could sell almost everything they produced. If anything, the problem was one of shortages, not surplus.

Between 1981 and 1985, however, total federal spending on farm programs skyrocketed to over $60 billion. Several factors led to this increase: inflation slowed, reducing commodity prices; the global recession lowered demand worldwide; and the value of the dollar soared, raising the prices of American farm products and thus reducing exports. In addition, two years of bumper crops worldwide created global surpluses and placed additional downward pressures on prices. In fiscal 1983, federal government outlays for farm price and income support programs totaled $18.9 billion, an increase of $12.3 billion in two years. To this must be added another $9.4 billion worth of payment-in-kind (PIK) commodities committed in 1983 to compensate farmers for reducing their crop acreage in order to reduce inventories. These programs cost taxpayers almost $12,000 per farm. And in 1985, federal spending is already estimated at nearly $17 billion. Thus, while federal expenditures have been curtailed in many domestic program areas, the cost of farm programs has exploded.

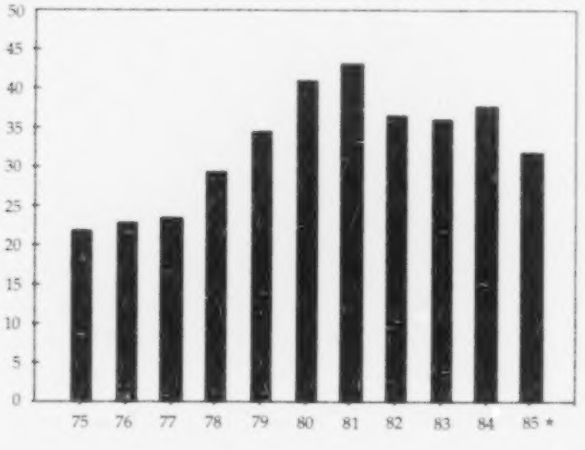
There are several significant problems with these programs. First, they are expensive – the cost of agriculture programs in 1981 was $4 billion, rising to $12 billion in 1982 and $28 billion in 1983. Second, the minimum price established by U.S. agricultural price support programs are, at times, above world market prices. Indeed, in 1984, the world price for wheat was $2.10 per bushel while the U.S. price was $3.53. By restricting any decline in prices, agricultural programs have caused U.S. commodities to become uncompetitive in international markets, thus reducing U.S. farm sales abroad. Consumers and taxpayers bear the cost of these farm programs through increased taxes and higher food prices. Third, most of the benefits of agricultural programs accrue to owners of large farms. Half of direct federal payments in agriculture go to only 15 percent of farmers, generally the largest ones. If current funding policies continue, taxpayers will spend another $52 billion over the next four years supporting approximately 800,000 farmers.

Recent Agricultural Performance

Numerous economic and political factors are cited as recently having an adverse impact on American agriculture. High interest rates, the high value of the dollar, trade embargoes, unfair trade practices by our competitors, declining farm values, widely fluctuating commodity prices, and commodity prices below the cost of production have all been named. The inability of a larger than usual number of farmers to meet debt obligations is offered as evidence that the combination of these factors and the U.S. government's price support policies are leading to the ruin of American agriculture.

To begin to understand the problem, let us review what has happened to American agriculture over the last decade. In the 1970s, global economic growth, a depreciating dollar, changes in the Soviet import policy, and several crop failures around the world, contributed to more than a fivefold increase in U.S. agricultural exports (see Chart 1). The volume of world agricultural trade grew by 45 percent, while global farm production grew by only 24 percent. These conditions, together with accelerating inflation, dramatically raised U.S. farm incomes. At the same time, expectations of higher inflation and low real interest rates, provided the incentives for huge investments to expand the productive capacity of U.S. farming and agribusiness. As a result, total U.S. farm debt rose from $49 billion to $155 billion and the average price of farmland grew more than threefold during the 1970s. During that period, American agriculture became a capital-intensive, export-dependent sector of the U.S. economy. As a result, it became much more sensitive to interest and exchange rate variability than it had been in the past.

CHART 1
U.S. EXPORTS OF AGRICULTURAL COMMODITIES
($ billions)
1975–1985

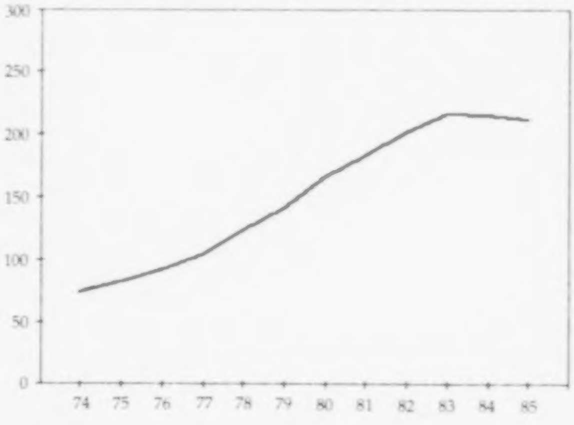


*85 – Estimate

Source: U.S. Department of Agriculture

By 1980, American farmers had experienced eight years of unprecedented prosperity. Total farm income rose from $62.1 billion in 1971 to $147 billion in 1979. Commodity prices stayed high and the export value of American crops increased from $7 billion in 1970 to $41 billion in 1980. New and established farmers rushed to expand operations, borrowing heavily to buy land and equipment, and soon found themselves with large debt service bills. Farm debt jumped from $73 billion in 1974 to $212 billion this year (see Chart 2). Interest payments in the farm sector grew sixfold, from $3.8 billion in 1970 to $19.1 billion in 1981. These payments have become the largest agricultural production expense, costing about $22 billion this year. The heavy borrowing was backed by rapidly escalating land prices. Between 1974 and 1981, the average price of farmland in the U.S. rose from $302 an acre to $795. Prime Midwestern land shot up to $4,000 an acre.

CHART 2
TOTAL FARM DEBT
($ billions)
1974–1985



Source: U.S. Department of Agriculture

After 1981, two recessions, bumper crops around the world, and the rising dollar made it increasingly difficult for U.S. agriculture to compete. The speed with which market conditions changed in the early 1980s rendered adjustments within the agricultural sector and in U.S. farm policies difficult to achieve. Those farmers who borrowed too much and paid too much for land in the late 1970s found themselves in difficulty. Because average farmland prices nationwide have fallen by 12 percent between 1981 and 1984, some highly leveraged farmers now find their loan principal larger than the market value of their land. Since peaking in 1981, land values have declined by as much as 50 percent in Iowa and Nebraska, and by 40 percent in Ohio, Illinois, Indiana, Minnesota and Missouri. The problem was also exacerbated by the Agriculture and Food Act of 1981, which established rigid price supports that tended to price U.S. commodities out of the world market. Thus, farming and agribusiness in the U.S. has been left with substantial excess capacity. The combined effect of these changes reduced the total value of U.S. farm exports by about 15 percent between 1981 and 1984.

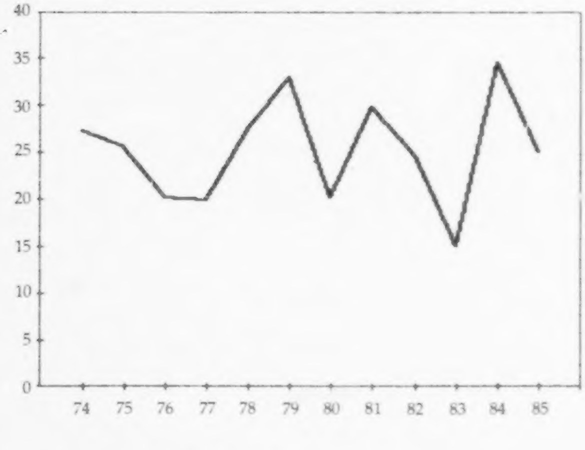
Distribution of Farm Debt

Although more than three-fourths of the nation's 2.4 million farmers are not in financial difficulty, the minority most burdened with debt is dragging down more and more rural banks, threatening the viability of the agricultural financial system. Although not all farmers are flirting with bankruptcy, they are, nonetheless, facing much lower incomes (see Chart 3). Indeed, an Agriculture Department survey released in July concluded that 50 percent of all farm operators had negative cash flow in 1984. Yet, most of them were able to stay in business by selling assets, or borrowing more. All farm operators, including those with no debt, will realize only $22 billion to $26 billion in net farm income this year, down from $34.5 billion in 1984. According to another study by the Department of Agriculture, only 6.5 percent of all farmers are actually insolvent or on the verge of bankruptcy.

CHART 3

NET FARM INCOME

($ billions)



Source: U.S. Department of Agriculture

Farmers with negative cash flow and an already high debt burden are of particular concern. (These are the farmers who borrowed extensively during the 1970s.) The Department of Agriculture estimates that eight percent of all farmers have debt-asset ratios over 70 percent. This group owes 29 percent of outstanding farm debt. Another 11 percent of farmers have debt-asset ratios of 40 to 70 percent. Most analysts point to farmers operating with debt to asset ratios greater than 40 percent as the group most susceptible to financial stress. But, over 80 percent of all farms have a debt-asset ratio of less than 40 percent, generally indicating a strong financial position.

The Southeast, Southern Plains, Pacific, and Cornbelt regions have the largest share of debt owed by farmers with debt-asset ratios over 70 percent. These regions also have the largest proportion of technically insolvent farmers. This is not surprising since these areas, with a large number of grain, livestock, and dairy farmers have the largest share of medium-size farmers, and experienced the steepest drop in farmland values in 1984.

The Credit Crunch

Although financial stress may persist for only a minority of farmers, the huge overhang of debt will continue to burden the farm sector. In recent months, the financial problems have spread beyond the small, rural commercial banks which have been the principal providers of short-term operating loans to farmers to other major lenders such as the Farm Credit System, Farmers Home Administration, individuals, and the Commodity Credit Corporation (see Table 1).

TABLE 1

DISTRIBUTION OF FARMERS' DEBT BY LENDER

(percent)

January 1, 1985

	Type of Debt		
Lender	secured by real estate	not secured by real estate	Total
Commercial Banks	11.7%	16.5%	28.2%
Federal Credit System	26.2	8.7	34.9
Farmers Home Administration	9.7	3.8	13.5
Commodity Credit Corporation	0.2	1.2	1.4
Individuals	10.0	4.3	14.3
Others	4.2	3.5	7.7
TOTAL	62.0	38.0	100.0

Source: Financial Characteristics of U.S. Farms, January 1985, U.S. Department of Agriculture

Farm financial stress has affected the performance of the nation's farm banks—banks with more than a fourth of their loans in agriculture. Loan losses at these banks at the end of 1984 were four times larger than in 1980. The Federal Deposit Insurance Corporation's (FDIC) problem bank list includes 402 farm banks as of September, up from 371 in June. Forty-three of the 81 banks that have failed so far this year were agricultural banks. Iowa, Kansas, Minnesota, Missouri, and Nebraska account for more than half the national total of such potentially vulnerable agricultural banks. And, in South Dakota and Nebraska 70 percent of banks have more than half their loans tied up in farming.

The Farm Credit System (FCS), a federally-sponsored nationwide network of 37 farmer-owned banks and hundreds of cooperative associations specializing in long-term farm real estate lending, disclosed that about 19 percent of its loans are in trouble. The system holds over 34 percent of the nation's $212 billion of farm debt, ranking it ahead of commercial banks (28 percent) as agriculture's largest creditor. The FCS, funded with $73 billion of debt securities owned by insurance companies, banks and investors, estimated this year's losses at $400 million, up from $260 million in 1983. The system's earnings have plunged by 50 percent over the past few years, and last year its Production Credit Associations sustained their first overall loss in 50 years. FCS officials have recently requested a federally-directed rescue.

The Farmers Home Administration (FmHA), an agency of the Department of Agriculture, with nearly $25 billion in outstanding loans, holds about 15 percent of the nation's farm debt. In June, $5.8 billion, or over a quarter of its loans were "delinquent"; $3 billion of them were more than 3 years overdue. The agency is signing up many first time borrowers sent by banks that will not refinance former customers. As a result, the FmHA has allotted more funds for loans, partly with money originally to be lent out later this year.

Although farm banks, the FCS and the FmHA are likely to have more loan delinquencies and loan loss problems throughout this year, it is important to keep the situation in perspective. There is no compelling evidence that the commercial banking system or the federal agencies are in jeopardy. To the contrary, evidence suggests that most agricultural lenders have enough resilience to ride out the current period.

Conclusion

American agriculture is in the midst of a difficult but necessary adjustment. The current and prospective financial problems resulting from adjustment to slower world economic growth, increased international competition, and greater price stability are putting farmers and their lenders under stress. It is important that this adjustment to rapidly changing economic conditions be completed without rupturing the social and political fabric of the nation's rural economy. The challenge for all those involved in the agriculture sector is to use both private and public sector mechanisms to develop a *long-term* solution to the current farm problem.

Currently, the choices confronting U.S. agriculture are either reduced government intervention and increased reliance on market forces to determine farm prices, or still further dependence on government attempts to bring supply and demand into balance through costly supply control and export subsidy programs. Clearly, an economic environment in which farmers are provided the opportunity to seek profitability in a dynamic and expanding marketplace is an environment consistent with the best interests of consumers and of all segments of the agricultural sector. Traditional policies that keep domestic prices above world prices and maintain excessive levels of production must be abandoned. In their place, flexibility must be introduced to keep U.S. products competitive in changing world markets.

WILL ANOTHER BUDGET RESOLUTION BE BROKEN?

by

*William P. Orzechowski and Cesar V. Conda**

To hear our Congressmen talk, one might get the impression that fiscal responsibility is Washington's number one concern. With all the congressional hand-wringing over deficits and lavish federal spending, one might think that Congress was really set to do something about runaway federal spending. Think again, Congress is up to its old tricks. Most of the domestic spending reductions contained in the 1986 budget resolution are in the process of being evaded. The pattern is a familiar one – talk tough and then do nothing.

The recently passed budget resolution proposes to reduce the deficit by $56 billion in fiscal year 1986 and $277 billion over the next three years. Defense spending reductions and minor revenue increases comprise over 50 percent of the proposed savings in fiscal year 1986. Unlike the Senate's original plan, the compromise budget fails to incorporate important structural changes such as a freeze on Social Security and other retirement cost-of-living adjustments, and a wide range of program terminations. Instead, the compromise budget substitutes mild spending freezes and loosely defined spending reductions for the hard programmatic spending cuts in the Senate's original budget.

A short summary of how the congressional budget process works will be helpful in understanding how so many good intentions can slip between the cracks. The congressional budget resolution sets limits on outlays and revenues for the coming fiscal year which begins on October 1. Total government spending is divided into budget functions such as defense, agriculture, and transportation. The budget resolution sets aggregate spending levels for each of the 21 budget functions. The congressional authorizing committees are responsible for the substantive legislation that guides the spending in each federal program. The congressional appropriations committees determine the level of spending for each federal program. These committees are required to make sure that programmatic spending conforms to the limits set forth in the budget resolution.

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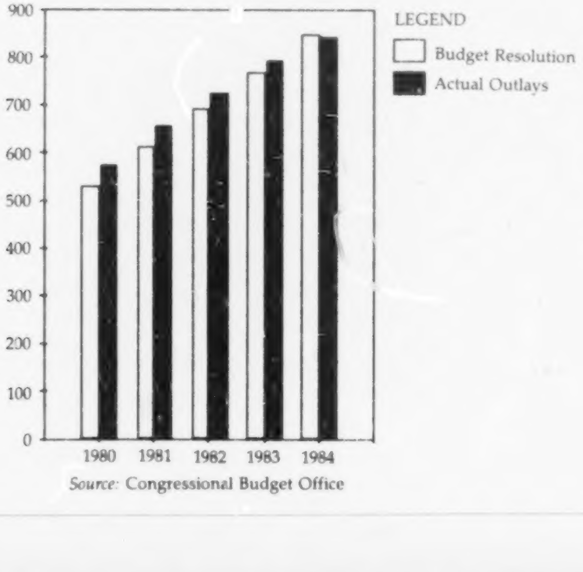
One of the few redeeming aspects of this year's budget plan is that it "reconciles" 70 percent of the proposed nondefense spending reductions over three years. Reconciliation instructions enforce the budget resolution by directing the congressional authorizing committees to make the changes in laws, bills, and resolutions required to conform with the binding totals, set forth in the budget resolution, for budget authority, revenues, and public debt. Reconciliation is supposed to give teeth to the budget resolution. But recent developments in the appropriations process indicate that total spending plans now incorporated in the appropriations bills, combined with spending under the jurisdiction of the congressional tax-writing committees, will exceed the budget resolution's outlay limits by a substantial margin. In other words, Congress is in the process of violating the already watered-down budget resolution that it just adopted.

Poor Track Record for Budget Resolutions

Preliminary estimates of this year's spending bills indicate that they will breach the outlay ceilings set forth in the budget resolution. This is not surprising given the poor track record of past budget resolutions in controlling federal expenditures. The Impoundment and Budget Control Act of 1974 created the budget committees, budget resolutions and the reconciliation process. Proponents believed that they had created an effective mechanism for budget control. However, federal spending has more than tripled—from $267 billion in 1974 when the law was enacted, to $950 billion in 1985. In the past five fiscal years, Congress has surpassed its own budget resolution by an average of $28 billion a year (see Chart 1). Although actual outlays remained just within the resolution's targets in fiscal year 1984, this by no means suggests that Congress has regained budget control. This year, actual outlays, based on the latest Treasury Department estimates, are running about $6 billion over the 1985 budget resolution's target.

CHART 1
FIRST BUDGET RESOLUTION
VS. ACTUAL OUTLAYS
($ billions)



Source: Congressional Budget Office

Errors in forecasting business cycles and the consequent changes in income support programs, such as unemployment insurance, account for some of the overruns in each year. However, since variations in economic activity tend to offset one another, the five year average of $28 billion is due mostly to the congressional bias toward higher spending and the weak enforcement provisions of the 1974 Budget Act. Congress is now agonizing over $22 billion of domestic spending reductions knowing full well that it will likely fritter away more than half of these savings in the appropriations process with deceptive budget techniques. Some of the more popular techniques to conceal spending include the following:

- *Underestimating program costs*—Special interests must deal with the charge that their spending program would "break the bank" and breach the budget resolution's targets. In response, unreasonably low cost estimates are employed to keep programs within the resolution's target. However, supplemental, or additional funding beyond the amount set at the beginning of the fiscal year, is required later in the year when the higher-than-expected program costs begin to emerge.

- *Underfunding a mandatory program*—Congress often agrees to cut funds from a federal program but refuses to enact the changes in law that would make the cuts possible. Consequently, funding runs out later in the fiscal year and supplemental funding is required by law to sustain the program.

- *Fund transfers*— The illusion of budget cuts is sometimes achieved by transferring funds from one government account to another and counting the transfer as a spending cut.

- *Out-year spending reductions*— The resolution's targets can often be avoided by planning for reductions in out-year spending. These "savings," however, tend to disappear by the end of the year in question. Congress can simply restore spending because the resolution's out-year targets are nonbinding and subsequent budget resolutions often overturn changes made in the past.

- *Postponing payments*—Phony budget cuts are often achieved by postponing payments made at the end of one fiscal year to the beginning of the next fiscal year.

This Year's Appropriations Bills are Over Budget

So far, this year's progress on the budget is following a familiar pattern. The House has completed action on ten of the 13 appropriations bills and, in the process, has failed to enact over half of the budget resolution's proposed domestic spending reductions. Either through outright disregard of the resolution's ceilings, or through deceptive budgeting, Congress is breaking its own budget. Indeed the violations have become so flagrant that Congress has had to keep some of these spending bills from reaching the floor. An amendment by Representative Gradison (R-OH) that would have brought the Ways and Means Committee spending bill within budget was submitted to the House Rules Committee. The Gradison amendment prompted the Rules Committee to send the bill back to Ways and Means with a recommendation to propose more reasonable spending levels before allowing the bill on the House floor.

Another example is the House agriculture authorization bill which sets U.S. farm policy for the next five years. As currently drafted, the legal requirements for farm programs in the bill will necessitate spending far beyond the limits incorporated in this year's budget. The major cause of this overspending is the use of outdated estimates of farm crop prices. In determining the level of funding for agricultural price supports and deficiency payments, the committee used the January farm crop price estimates assumed in the budget resolution. However, since crop prices have dropped in recent months, spending for price supports will be much higher. Using recent crop prices, the Department of Agriculture estimates that the agriculture bill will exceed the budget mark set by the budget resolution by approximately $5 billion in fiscal year 1986 and $16 billion over the next three years. The Agriculture Committees are fully aware of this problem, but refuse to incorporate the new crop estimates claiming that the January estimates assumed in the budget are binding on appropriations.

If this were not bad enough, the agriculture committees have employed other methods to subvert the budget process. For example, $3.3 billion in budget savings over three years will be achieved by postponing advanced deficiency payments after October 1 of each fiscal year. All this does is slightly delay the pay-out of agriculture subsidies in order to shift payments into the next fiscal year. The House Agriculture appropriations subcommittee intentionally underfunded a mandatory program by transferring $39 million from Food Stamps to another agricultural account and counting the transfer as a cut in Food Stamps.

The use of budgetary gimmicks is not confined to agricultural spending. In the House-passed Energy and Water Appropriation Bill, a spending cut of $217 million for energy supply research and development was assumed by transferring $217 million of balances to other accounts. In the House-passed Housing and Urban Development appropriations bill, the subcommittee underfunded by $1.1 billion the mandatory General Revenue Sharing Program and used these funds to increase discretionary programs. Supplemental funding will be required later in the fiscal year. The pending House Labor/Health and Human Services/Education appropriations bill underfunds several programs within the bill by at least $2.3 billion. This is achieved by deferring action on appropriations for the programs awaiting authorizing legislation and providing insufficient funds for student financial assistance programs under current law.

Fiscal discipline is fading in nearly every area of the budget. The Senate Budget Committee has estimated that the ten House-passed appropriations bills, excluding farm support payments, have breached the 1986 budget resolution by a total of $4.2 billion. Further, domestic spending programs within the jurisdiction of the House Ways and Means Committee are almost $1 billion over budget. In addition to the $5 billion overage in the farm bill, this brings the 1986 budget evasion total to over $10 billion. With the $100 billion plus Labor/HHS/Education bill yet to be considered, Congress will easily squander over half of the $22 billion in domestic budget cuts planned for fiscal year 1986. Moreover, the Senate has historically tended to add more spending to the House's appropriations bills.

Future Strategies to Control Spending

In the short term, there remain only two opportunities to directly enforce the budget resolution. One method is to offer amendments to appropriations bills to reduce spending for programs that substantially exceed the budget resolution's ceilings. However, recent efforts to reduce overspending through amendments offered on the floor have failed miserably, particularly in the House. An amendment by Representatives Michel (R-IL) and Olin (D-VA) that would gradually lower dairy price supports and save $1.2 billion over four years was defeated 244 to 166. Amendments offered by Representative Frenzel (R-MN) to reduce overspending in the Interior Appropriations bill and the Treasury/Post Office appropriations bill were also defeated by large majorities. An amendment offered by Representative Gradison to strike excessive Ways and Means-related spending was never granted a rule to be considered on the floor. Clearly, Congress does not possess the will to cut spending.

The second and more effective strategy would be for the President to veto spending bills. The Administration has suggested the possibility of using the Senate's original budget resolution targets as benchmarks to trigger a presidential veto. The Senate's targets are considered tougher than those contained in the budget resolution that ultimately passed both houses. Critics of this strategy charge that since both the House and Senate overwhelmingly approved the budget resolution, the President has no grounds for a veto and that such a veto would be easily overturned. However, a group of House members have gathered together the number of members required to sustain a presidential veto of any spending bill that is not consistent with $56 billion in real spending reduction.

Since the enactment of the Budget Control Act of 1974, Congress has been reluctant to accept changes to the budget process that would strengthen fiscal discipline. However, Senators Gramm (R-TX), Rudman (R-NH), Hollings (D-SC), and Boren (D-OK) have introduced an innovative proposal to be attached to the bill to raise the debt ceiling, that would reform the budget process and balance the budget by 1991. As of this writing, the Senate has passed this proposal to strengthen the budget process and reduce the deficit. The Balanced Budget and Emergency Deficit Control Act of 1985 would require a graduated reduction of federal budget deficits by setting deficit targets in each of the next four fiscal years starting at $180 billion in fiscal year 1986 and ending with a balanced budget by fiscal year 1991. Each year, the President would be required by law to submit a budget that does not exceed the maximum deficit target and the Congress would report a budget resolution that also does not exceed the maximum deficit. When the budget resolution is considered on the House and Senate floors, any amendments to the resolution that increase spending must be compensated by spending reductions elsewhere or explicit tax increases. At the start of the new fiscal year, if estimated deficits are greater than the deficit target, the President would be required to cut federal spending across-the-board by a uniform percentage to eliminate the deficit overage.

The Gramm-Rudman-Hollings-Boren bill is a temporary plan to balance the budget by fiscal year 1991. Permanent restraints on Congress' ability to tax and spend can only be achieved by enacting a constitutional balanced budget/tax limitation amendment.

Summary

This year's budget resolution is in the process of being whittled away. As of this writing, most of the spending bills that have passed either the House or the Senate exceed budget limits. Nevertheless, hope springs eternal. The latest public opinion polls indicate that the budget deficit remains a major concern of the American people. With continued public pressure, there is a good chance that efforts to strengthen the budget process may pass Congress and the President may actually exercise his veto powers.

1985: THE YEAR OF THE VAT?

by
*Terree P. Alverson**

The probability is high this year that the United States will enact a value-added tax (VAT) for the first time in its history. Proposals for VATs have appeared in both houses of Congress, and one bill has already passed the Senate Finance Committee. These value-added tax plans have appeared under the guise of comprehensive tax reform and within the Superfund toxic waste program.

Senator Roth (R-DE) has introduced the Business Transfer Tax (BTT), a form of the value-added tax, which will tax each manufacturing stage of a product, but which will essentially function as a tariff on imports because of offsets. The Senate Finance Committee has reported out a value-added tax called the Manufacturers' Excise Tax (MEET) to finance the Superfund program by taxing manufacturers with sales over $5 million.

The European Experience

The European community has had considerable experience with the value-added tax. Since 1957, all members of the European Economic Community have instituted VATs to increase government revenues. Most countries have various rates for different items, and most exempt certain necessities, such as food or medical care, from taxation.

The European experience has revealed some problems associated with VATs. Administrative costs for business are high, as each transaction must be documented and tax returns submitted on a regular basis. Government costs also increase, as the number of regulations issued to clarify the law rises. Problems with evasion and black marketeering of goods are more serious than originally anticipated.

The most common argument given by opponents of the VAT is that it is a hidden tax, and because of that, it is easier to raise the rate to accommodate increased government spending. The European experience may validate this claim; rates there have risen between 15 percent to 35 percent, depending on the item taxed.

Tax Reform

Both Congress and the Administration have deemed static revenue neutrality a prerequisite for overall tax reform. Many of the principal reform proposals stand accused of falling short of the revenue mark, and the juggling act has begun to insure that the final reform plan meets this requirement. To date, these attempts have proven unsuccessful. Recently, Senator Roth, partly in response to the revenue neutrality problem, introduced a Business Transfer Tax (BTT), which could be used along with comprehensive tax reform to lower individual rates while retaining revenue neutrality. Other members of the Senate Finance Committee have also expressed interest in the BTT or some other form of a value-added tax.

Senator Roth considers the inclusion of the BTT (S.1102) as the best way of achieving revenue neutral reform that is less biased against savings and investment. He has emphasized that his proposal is a substitute for lower tax rates and improved investment incentives, not a revenue raiser.

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Under the proposal, every manufacturer will be subject to the BTT. Tax liability will be calculated by totalling gross receipts and subtracting purchases of raw materials and other inputs. Salaries, interest payments, and dividends, however, will not be subtracted from the tax base. The rate of tax will be five percent on the "value added."

The BTT includes a provision under which each firm can use its tax liability as a credit against its FICA payroll taxes. These credited amounts will be transferred directly to the Social Security Trust Fund. However, no firm could escape its FICA tax liability. If the BTT generates insufficient revenues the firm must still pay the FICA tax. While goods destined for export will be excludable from the tax base, the tax would be assessed on the full price of imports. At the five percent level, the BTT with the FICA credit is estimated to raise approximately $20 billion a year. The bulk of the revenue raised – $17 billion – will be generated by the tax on imports, with only the remaining $3 billion coming from domestic producers.

In early October, Senator Roth introduced another version of the BTT. This new version will eliminate the FICA credit and allow the BTT to be fully deductable from either the corporate or individual income tax. The tax rate is raised to between eight percent and ten percent. Revenues from the tax would be used to offset revenue losses resulting from lower individual and corporate marginal tax rates, improvements in the capital cost recovery system, lower capital gains tax rates, and increased IRA contributions.

Congress is currently reauthorizing Superfund, the program to clean up toxic waste sites, whose five-year funding of $1.6 billion expires this year. Early indications are that Congress will raise the fund's level to somewhere between $7 billion and $10 billion – a five- to tenfold increase in funding. To ease the burden on petroleum and chemical companies, who now shoulder approximately 80 percent of the tax burden, both houses of Congress are showing interest in a VAT to finance the additional amount.

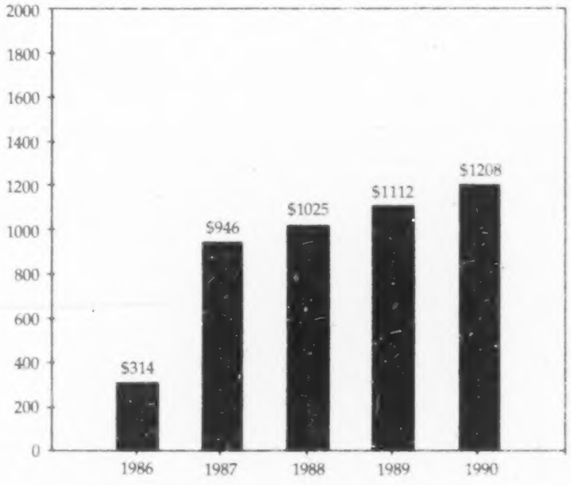
The Superfund Excise Tax or Manufacturers' Excise Tax would impose a new tax on all manufacturers with sales over $5 million ($10 million in the House version). The Senate Finance Committee recently approved a version of this tax, known as S.51. Under the S.51 formula, a tax rate of 0.08 percent applies to the sales price of, or gross lease payments for, tangible personal property in connection with a trade or business. The bill provides for a tax credit on purchases of property allocable to the cost of manufacturing goods. Imports are taxed at the border and exports are exempted.

Manufacturers would be required to file a new Superfund Excise Tax Return at the same time they file their regular tax returns, and to deposit funds quarterly. The amount of anticipated revenues as a result of the Superfund Excise Tax are shown in Chart 1.

CHART 1

SUPERFUND EXCISE TAX REVENUES

($ millions)



Advantages and Disadvantages

The outcome of these proposals is uncertain as several factors may work to defeat the passage of a VAT this year. The Reagan Administration is opposed to it and views any VAT as a tax increase. Many members of Congress, who recall the defeat of Al Ullman (D-OR), possibly due to his advocacy of the VAT, are hesitant to offer support. And economists and academicians have criticized some of the VAT's possible effects on the economy and the rate of growth in government spending.

Nevertheless, the VAT has some politically attractive features which could prove irresistable to Congress. It is a tax which is added on at each stage of the manufacturing process and thus, becomes embedded in the cost of a product. This distinguishes it from a sales tax, which is added directly at the retail level as a separate cost easily identified by the consumer. A hidden tax, such as the VAT, is politically attractive, as consumers are not aware of how much tax they are paying, and as a result, it becomes easier to raise the rate without public opposition. And once the administrative apparatus is in place, it is easy to raise the rate with little additional political and financial costs.

Because the VAT is levied on a very broad base, incremental increases in the rate raise large amounts of revenue, a decided advantage for our elected representatives. As a result, many are concerned that the VAT would become an easy vehicle for solving the budget deficit problem without having to raise highly visible taxes or reduce government spending.

Although most Western European countries employ VATs, the U.S. has previously avoided such a tax because of many perceived disadvantages and criticisms. The major criticism levied on the VAT is that it is a hidden tax, and the rate is too easily raised. This is witnessed by Europe's experience with ever-increasing VAT rates, some now above 20 percent. Critics fear the opening of a Pandora's box with the enactment of a VAT in the U.S.

Since many European countries do employ a VAT, it has been suggested that it would be to the U.S.'s trade advantage to adopt one as well. Because the tax is levied on imports and not exports, it is, at times, recommended as a less harmful revenue raiser that would offset import taxes paid by U.S. exporters as their products enter other countries.

The current income tax system encourages consumption by raising the cost of saving and investing. A consumption-based tax like a VAT, however, removes the bias towards consumption, leaving the choice between savings, investment and consumption neutral.

Many analysts have noted that, unless certain exemptions are made for essential items such as food, the VAT like other consumption-based taxes, is a regressive tax. On the other hand, others note that once exemptions are allowed, the tax becomes complicated to administer and loses its revenue raising ability.

Senator Roth's original proposal is structured so that at a low rate (currently set at five percent), the tax would offset a company's FICA liability only, and not require any increase in tax payment. Therefore, at such a low rate, the majority of revenue from the BTT would result from a tax on imports. It has been suggested that this would make the BTT primarily an import tax and could be viewed as a protectionist measure. Such a tax increase would raise import prices and reduce foreign sales in the U.S., lowering foreign profits. This would reduce the ability of other countries to purchase our exports, and possibly exacerbate our trade deficit. In addition, if the tax rate were raised above the FICA liability level, more revenues would flow from domestic business, resulting in higher prices for American goods purchased domestically.

Senator Roth asserts that the BTT will reduce the FICA bias against labor, leading to the creation of new jobs. This may prove to be an advantage to small businesses, who are relatively more labor-intensive. However, to the extent that it remains a tax on business (especially as the rate rises), it reduces profits, and could be perceived as a tax increase on capital formation by encouraging the hiring of labor over capital investment in some cases.

Senator Roth's bill demands the BTT be used in conjunction with overall tax reform to offset any revenue loss from lower individual marginal rates. However, because corporate taxes are paid by individuals, visible tax payment made through the personal income tax would be replaced under the BTT by hidden taxes paid by individuals through the mechanism of the corporate income tax.

Conclusion

The success or failure of a VAT probably depends on three developments: (1) the passage of an increased Superfund bill that includes the Manufacturers' Excise Tax, (2) the passage of a comprehensive tax reform package, or (3) significant long-term deficit reduction by the Congress. The Superfund Excise Tax has been accused of allowing the "camel's nose under the tent." Many have expressed concern that once a VAT is in place, even though initially limited to one program, it will not be long before it is expanded. Congress has, in the past, seemed unable to pass *significant* budget reductions and is continually faced with massive deficits, so the potential for continued tax increases exists. In the short-term, a BTT might appear as part of comprehensive tax reform (in exchange for lower marginal rates), or in the long term, it might be enacted separately as an additional tax, as a politically convenient method for deficit reduction.

TRENDS IN COMMERCE NOTES ON TABLE II OCTOBER, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—The Department of Commerce's "flash" estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—anticipates that the inflation-adjusted growth rate for the third quarter will be 2.8 percent. This is an improvement from the second quarter when the economy grew at a revised 1.9 percent annual rate and a real boom compared to the 0.3 percent growth rate of the first quarter. Personal consumption expenditures and government purchases are expected to account for most of the third quarter increase. Residential and business investment, both of which were growing rapidly in the second quarter, are expected to show little change, while inventories should continue to decline. Net exports are also expected to remain at about the same level as during the second quarter.

The Services Sector—Employment in service sector establishments rose by 0.3 percent in September and is now 4 percent above its year-ago level. This compares with a 0.3 percent decrease in employment in the goods producing sector in September, and a 0.4 percent increase from last year.

August witnessed a reversal in the trend toward rising purchases of consumer services relative to consumer goods. Purchases of durable goods increased by 6.5 percent, compared to a relatively small 0.6 percent increase in services. August data also indicate that purchases of goods, before adjusting for inflation, were up 7.3 percent from their level of last year, while purchases of services rose by 8.9 percent during the same period. Consumer purchases of services now comprise 50.7 percent of personal consumption expenditures compared to 50.4 percent in August 1984. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, hit a record 30.9 billion revenue passenger miles, an increase of 11.9 percent from last year. The previous record was set in July when 30 billion revenue passenger miles were flown. For the first eight months of 1985, major U.S. carriers reported a 13 percent increase in revenue passenger miles flown from the same period in 1984.

Money Supply–The nation's money supply–as measured by M-1, currency in circulation plus demand deposits–increased by 1.7 percent from July to August. The money supply has been growing at a 16.8 percent seasonally adjusted annual rate in the latest three-month period, and a 12.9 percent annual rate for the last six months. This is far above the Federal Reserve's target range of four to seven percent.

Employment–The civilian unemployment rate dipped to 7 percent in August, and then inched back up to 7.1 percent in September. The small September increase in the unemployment rate is the result of a surge of new entrants into the labor force rather than job losses. Civilian employment–as measured by the monthly survey of households–increased by 372,000 persons (seasonally adjusted) following an increase of 310,000 from July to August. The number of nonagricultural payroll jobs–as measured by the monthly survey of business establishments–increased by 128,000 in September, reflecting an across the board gain, including an increase in manufacturing jobs.

Prices–The Consumer Price Index for all urban consumers (CPI-U) increased a meager 0.2 percent in August for the fourth consecutive month. The slowdown in the rate of growth of consumer prices that occurred in the last four months reflects lower prices for used cars, energy, and foods, all of which had registered price increases in the first four months of the year. These lower prices partially offset the acceleration in shelter costs, which rose at an 8.1 percent annual rate in the latest four months, and medical care costs, which have been increasing at a 7.8 percent annual rate. Consumer prices have been increasing at an annual rate of 3.3 percent in 1985 compared to 4 percent for all of 1984. The pace of increase in consumer prices slowed to a 2.4 percent annual rate in the latest three month period, significantly below the 4.1 annual percent rate experienced in the first quarter.

Wholesale prices of finished goods fell 1.1 percent in September and were up 0.2 percent from their year ago level. The index for energy prices was down for the fourth consecutive month after substantial increases in April and May. Consumer food prices showed a 0.9 percent decrease in September, after falling 0.7 percent in August. The index for consumer goods other than foods and energy fell 0.5 percent, after showing no change for a month earlier. Most of the September drop was due to a 3.8 percent decrease for passenger cars and a 2 percent decline in light motor trucks.

Crude goods prices edged down 0.3 percent in September, far less than the 2.4 percent decrease in August. A slower rate of decline for many foodstuff items was chiefly responsible for this smaller decrease. Crude food prices fell 0.7 percent in September following a 3.8 percent drop in August. Prices of crude energy materials rose 0.4 percent, after falling 0.9 percent in August. The prices of crude nonfood materials, other than energy declined 0.6 percent.

Housing Starts–Privately owned housing units were started at a seasonally adjusted annual rate of 1,749,000 in August, six percent above the July level. Building permits, an indicator of future activity in the home building industry, increased four percent in August and were 14 percent above year-ago levels, indicating that housing starts will probably continue to increase over the next few months. In addition, household formations, which had slowed in the last recession, appear to be on the rise again, indicating a potential increase in the demographic demand for new housing units.

Industrial Production–August data showed a 0.5 percent increase in manufacturing output and a 0.3 percent increase in total industrial output. The August increase in manufacturing output showed gains in virtually every sector for the first time since last March. The automotive sector registered its strongest gain in August partly due to increased output of light trucks. Output of defense and space products continued to register strong gains, up 0.9 percent in August and nearly nine percent from August 1984. Business equipment output also increased 0.2 percent in August following three months of declines. Construction material output continued to increase in August.

The capacity utilization rate in manufacturing was up 0.2 percent in August to 80.2 percent. Motor vehicles, aerospace and miscellaneous transportation, and petroleum products industries all showed the largest gains in utilization rates. Despite unfounded rumors of an eroding

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Jul/85	239.0	238.1	236.9	0.4	0.9
Gross National Product ($B)	III/85	3,909.4	3,853.1	3,694.6	1.5	5.8
Gross National Product (72$B)	III/85	1,683.0	1,671.3	1,645.2	0.7	2.3
Money Supply (M1) ($B)	Aug/85	606.0	595.8	548.9	1.7	10.4
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Aug/85	2,541.5	2,510.4	2,350.1	1.2	8.1
Personal Consumption Expenditures (72$B)	Jul/85	1,104.9	1,101.6	1,066.1	0.3	3.6
Disposable Personal Income ($B)	Aug/85	2,713.7	2,708.8	2,605.4	0.2	4.2
Disposable Personal Income (72$)	Jul/85	1,192.2	1,187.8	1,174.3	0.4	1.5
Personal Savings Rate (%)	Aug/85	2.8	3.8	6.7	-1.0[b]	-3.9[b]
Civilian Employment (millions)	Sep/85	107.5	107.2	105.4	0.3	2.0
Civilian Unemployment Rate (%)	Sep/85	7.1	7.0	7.4	0.1[b]	-0.3[b]
Average Hourly Earnings	Sep/85	$8.64	$8.59	$8.40	0.6	2.9
Consumer Price Index (All Urban, 67=100) [a]	Aug/85	323.5	322.8	312.9	0.2	3.4
Purchasing Power of the Dollar (67=$1.00) [a]	Aug/85	0.310	0.310	0.320	-0.186	-3.22
Prime Interest Rate (%) October 2, 1985		9.5	9.5	12.75	0.0[b]	-3.25[b]
Retail Sales ($)	Sep/85	120.3	117.0	108.4	2.7	10.9
SERVICES SECTOR						
Employment in Services (Millions)	Sep/85	73.2	73.0	70.4	0.3	4.0
Consumer Purchases of Service ($B)	Aug/85	1,288.9	1,281.6	1,183.4	0.6	8.9
Consumer Purchases of Service (72$B)	Jul/85	512.1	511.4	493.6	0.1	3.7
Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Aug/85	30.9	30.0	27.6	5.3	14.7
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	II/85	221.0	222.3	246.0	-0.6	-10.2
After Tax [a]	II/85	137.4	137.0	150.2	0.3	-8.5
Industrial Production (67=100)	Aug/85	124.8	124.4	123.5	0.3	1.1
Capacity Utilization Rate (Mfg.) (%)	Aug/85	80.2	80.0	81.8	0.2[b]	-1.6[b]
New Housing Starts (thou. units)	Aug/85	1,749.0	1,647.0	1,590.0	6.2	10.0
Net Business Formation (67=100) [a]	Aug/85	119.0	118.0	119.1	0.8	-0.1
New Business Incorporations (Thousands)	Feb/85	54.5	53.3	53.6	2.4	1.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100)	II/85	164.2	163.3	157.6	0.6	4.2
Unit Nonlabor Costs (77=100)	II/85	161.7	100.3	159.5	0.9	1.4
Producer Price Indices (67=100)						
Crude Materials	Sep/85	292.4	295.5	326.2	-0.3	-10.4
Intermediate Goods	Sep/85	317.9	317.8	320.3	0.0	-0.7
Finished Goods	Sep/85	290.2	293.5	289.5	-0.6	0.2
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100)	Aug/85	636.7	594.0	565.7	7.2	12.7
Federal Government Debt Outstanding ($B) [a]	Jun/85	1,779.0	1,758.3	1,517.2	1.2	17.3
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	II/85	347.7	360.7	362.4	-3.6	-4.1
Imports of Goods & Services ($B)	II/85	441.6	435.2	421.1	1.5	4.9
Balance on Goods & Services ($B)	II/85	-93.9	-74.5	-58.7	26.0	60.0
WHAT'S AHEAD?						
Index of Leading Indicators (67=100) [a]	Aug/85	170.1	169.0	164.4	0.7	3.5

NOTES: All data seasonally adjusted unless otherwise noted
[a] Not seasonally adjusted
[b] Percentage point difference

industrial base, our ability to produce continues to increase. Manufacturing capacity rose 0.8 percent in the second quarter of 1985, an increase of 3.3 percent from a year ago.

Productivity–Nonfarm business productivity increased at a 1 percent annual rate in the second quarter, compared to a 3.1 percent decline in the first quarter. The first quarter decline was the most severe since the fourth quarter of 1981, when productivity dropped 4.4 percent. In the second quarter, output in the nonfarm business sector grew by 2 percent as a result of an increase of 1.2 percent in the number of hours worked and a 1 percent increase in productivity.

Interest Rates–At 9.5 percent, the prime interest rate is 3.25 percentage points below the rate at this time last year. Three- and six-month Treasury bill rates at the end of September were virtually unchanged from their levels at the end of August. There was also very little movement in the longer term seven-year Treasury notes and thirty-year bonds during September.

Business Failures and Formations–Dun and Bradstreet's Index of Business Failures indicates that business failures at the end of August were at their highest level in two months. Business failures in the first eight months of 1985 increased by 9.8 percent from their year-ago levels and total business closings were up about 17 percent.

Dun and Bradstreet reported that 105,558 new business corporations were formed in the first two months of 1985, an increase of 1.1 percent from the previous year. Five states had increases of ten percent or more, and six of the nine census regions reported more new business corporations formed in the first two months of 1985 compared to 1984. The Middle Atlantic and Mountain States reported the largest gains while the Pacific region had the steepest decline. The states reporting the largest increases in new corporations in the first two months of 1985 were South Carolina, Louisiana and New Hampshire.

Federal Spending–The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased 12.7 percent in August from its year-ago level, after adjusting for the fact that two Social Security payments were made in August 1984 because of the timing of the Labor Day weekend. This is nearly four times the rate of increase in consumer prices over the last twelve months. In the first eleven months of fiscal year 1985, federal expenditures increased by 9.2 percent, nearly three times as fast as prices, indicating a real increase in federal spending of about six percent from their year-ago level. Federal receipts, during the same period, have risen by 10.3 percent as a result of double digit increases in personal income taxes, corporate income taxes, and social insurance taxes. The data on tax receipts indicates that federal tax revenues continue to increase at a faster rate than increases in income. The faster growth of taxes and federal outlays than prices or the economy indicates that we must concentrate on expenditure reduction in order to bring the federal deficit under control.

Personal Savings–After a savings bulge which resulted from delayed tax refunds in May and pushed the personal saving rate up to 6.3 percent, consumers went on a spending spree in August. Personal consumption spending rose 1.2 percent for the month, about six times as fast as the 0.2 percent increase in after-tax income. This brought savings down to a lackluster 2.8 percent of after-tax income for August.

Retail Sales–Retail sales increased 2.7 percent in September, following a 2.3 percent increase in August. Durable goods sales rose 6.2 percent in September due to a more than 9.6 percent increase in auto sales from August and a 34.2 percent increase in auto dealers sales from their levels last year. Nondurable goods inched up 0.6 percent in September following a 1 percent increase in August. Department store sales fell 2 percent for the month. However, the combined increase in automotive sales and other consumer durable goods shows a significant revival of consumer confidence in the closing days of summer.

Trade Deficit–The trade deficit continued to grow in the second quarter. On a goods and services basis, the trade deficit increased to $94 billion in the second quarter from $74.5 billion in the first quarter. The deterioration is largely due to a $13 billion decline in exports, while imports increased by $6.4 billion. On a monthly basis, the merchandise trade deficit declined to under $10 billion in August for the first time in 1985. The reduction was mainly the result of reduced imports and a small 0.7 percent increase in exports. Over half of the decrease in the merchandise trade deficit was the result of a lower level of petroleum imports. However, exports of agricultural and petroleum products increased, offsetting the decline of manufactured goods exports.

What's Ahead–The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.7 percent in August, with seven of the eleven available indicators up, three were down and one was unchanged. This follows a revised 0.7 percent increase for July that was previously reported as a 0.4 percent gain. Most encouraging about the August data was the fact that the three indicators which are related to employment–average workweek in manufacturing, initial unemployment claims and new business formations–all showed improvements. This indicates continued strong job gains in the months ahead.

WANT TO BUY A ROBOT?

The answer to that question is increasingly yes.

According to the Robotics Industry Association, the United States had approximately 6,300 operating robots in 1982. This was less than one-fifth the number of robots operating at that time in Japan. Significantly, 240 of the 6,300 American robots were located in one factory in Smyrna Tennessee, a Nissan truck assembly plant, owned by Nissan Motors of Japan.

During 1983, the robot population of the United States increased by 55 percent to 3,500. This included 2,500 domestically produced robots and about 1,000 imported robots. The Robotics Industry Association reports that in 1984, shipments of the domestic robotics industry were up about 68 percent from its 1983 level to nearly 5,136.

The average robot in the United States currently costs about $64,739 per installation and has a life expectancy of about five to eight years. In addition, there is usually a cost of redesigning the configuration of the workplace which could add substantially to the installation cost.

Presently, the largest users of robots are in the high paying auto industry where compensation costs are currently running about $23.00 per hour. Robots replacing these workers cost about $6.00 per hour to operate. Robots also have other advantages over human workers in that they reduce work environment costs. This is especially true when workers are subject to toxic substances, such as lacquers, asbestos and other toxic and carcenogenic materials. The robots currently being used are eliminating dull, dangerous and dirty jobs.

LAGOS, TOKYO, NEW YORK, ABU DHABI MOST EXPENSIVE CITIES IN THE WORLD

According to a recent survey by the Union Bank of Switzerland, Lagos, Nigeria; Tokyo, Japan; New York City, U.S.A.; and Abu Dhabi in the United Arab Emirates are rated as the four most expensive cities in the world. The following cities ranked next in terms of cost of living: Manama (Bahrain), Chicago, Houston, Jeddah (Saudi Arabia), Oslo, Los Angeles, Seoul, and Helsinki.

The U.S. has become relatively more expensive in the past year because of the high value of the dollar, but salaries have largely kept pace with the increase in the cost of living.

The survey indicates that the best value, in terms of goods and services purchased, occurred in Lisbon, Rio de Janerio, Istanbul, and Bangkok. Taking 12 professional groups as a basis for its calculations, the survey found that the best paid professional workers are in North American and Switzerland.

FOREIGN-OWNED MANUFACTURING FIRMS ARE SPREADING IN THE U.S.

Where do foreign corporations locate their businesses in the U.S.? According to the Conference Board, a New York-based business research group, there were 325 new foreign manufacturing investments across the U.S. last year. The largest number occurred in New York, with a total of 49 new manufacturing investments. California ranked second, with 33; North Carolina, third, with 20; Georgia, fourth, with 17; and Texas, fifth, with 16. New Jersey and Illinois had 15 new foreign-owned investments each. These numbers reflect both U.S. facilities acquired last year by overseas concerns as well as new or expanded plant construction.

The report emphasizes that foreign-owned investment is spreading beyond the industrial belt to other areas of the country as well. For example, the assembly line at Japan's Nissan Motor Company in Tennessee has been turning out small pick-up trucks since 1983. Several other states which have experienced increases in foreign manufacturing investments are Washington, Kentucky, Alabama, and Oregon.

PERSONAL INCOME PROJECTIONS TO THE YEAR 2000

According to projections by the U.S. Commerce Department's Bureau of Economic Analysis, personal income in the United States is expected to increase 2.6 percent per year from 1983 until the year 2000. The states enjoying the largest percentage are projected to be Arizona, Nevada and Utah. Pennsylvania, Illinois and New York are anticipated to have the smallest percentage increases in personal income over the next 15 years.

The 10 states expected to have the largest average annual increases in personal income are: Arizona (4.3%), Nevada (3.9%), Utah (3.8%), Florida (3.5%), Colorado (3.5%), Wyoming (3.4%), Alaska (3.3%), New Hampshire (3.1%), New Mexico (3.1%), and Vermont (3.1%).

Among the 10 states expected to have the lowest average annual increases in personal income are: Pennsylvania (1.9%), Illinois (1.9%), New York (1.9%), Ohio (2.0%), West Virginia (2.0%), Michigan (2.1%), Maryland (2.2%), Iowa (2.2%), Missouri (2.2%), and Delaware (2.3%).

Exchange Value of the Dollar

(WEIGHTED AVERAGE INDEX)